CAPITAL ASSISTANCE ACT AND DEPOSIT INSURANCE FLEXIBILITY ACT

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 2531

TO PROVIDE FLEXIBILITY TO THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION AND THE FEDERAL DEPOSIT INSURANCE CORPORATION TO DEAL WITH FINANCIALLY DISTRESSED INSTITUTIONS

S. 2532

TO PROVIDE FLEXIBILITY TO THE FEDERAL DEPOSIT INSURANCE CORPORATION, THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, AND THE FEDERAL SUPERVISORY AGENCIES TO DEAL WITH FINANCIALLY DISTRESSED DEPOSITORY INSTITUTIONS

MAY 26 AND 27, 1982

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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CAPITAL ASSISTANCE ACT AND DEPOSIT INSURANCE FLEXIBILITY ACT

WEDNESDAY, MAY 26, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9 a.m. in room 5302 of the Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Lugar, D'Amato, Schmitt, Brady, Riegle, Proxmire, Cranston, and Dixon.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

I must admit that I came very close to starting the Banking Committee late for the first time in 17 months; but fortunately, close is only good in horseshoes.

This morning, the Banking Committee begins hearings on legislation designed to provide temporary relief for the financial problems of thrift institutions.

S. 2531 would provide capital assistance to FSLIC- and FDIC-insured institutions with less than 3 percent net worth. S. 2532, which I introduced by request, would provide the FDIC and the FSLIC with additional powers to merge and provide assistance to failing institutions.

During the past year, thrift institutions have suffered from high interest rates, and mismatched assets and liabilities. Thrifts have served the American public well during the past 50 years, by providing housing credit and promoting savings. Unfortunately, they have succeeded so well in making reasonably priced mortgage loans that they have not had any earnings for the past year and a half. As losses have accumulated, there have been numerous mergers among thrift institutions, many of which have involved FSLIC and FDIC financial assistance.

The merger and assistance programs of the FSLIC and the FDIC have resulted in substantial financial commitments during the past 15 months, amounting to $3.1 billion—$1.4 billion for FSLIC and $1.7 billion for the FDIC.

Thus, it is obvious that the Federal insuring agencies have been expending considerable sums to preserve the strength of our financial system. Congress must now consider expanding the merger assistance programs already instituted by the FDIC and the FSLIC, to insure that well-managed thrift institutions, which have been

following the dictates of Government policies during the past five decades, be given a chance to survive their temporary difficulties.

Capital assistance envisioned by my bill would authorize the FSLIC and the FDIC to issue promissory notes in exchange for capital certificates issued by depository institutions, the effect of which would be to increase the net worth of capital accounts of affected institutions.

For institutions with 2 to 3 percent net worth, the assistance would equal 30 percent of the institution's actual losses which, in effect, are reducing the institution's net worth. For institutions with 1 to 2 percent net worth, assistance would be in the amount of 40 percent of actual losses. For institutions with zero to 1 percent net worth, the assistance would be equal to 50 percent of actual losses.

This assistance program would involve an exchange of financial instruments and would not result in budget authorizations or appropriations.

The legislation will not maintain all institutions at a particular level. As such, it does not remove the risk element from the thrift business environment. It does provide assistance to institutions in such a way as to slow down the merger process, continue market discipline, and provide institutions which have the ability to overcome their problems a better chance for long-term viability.

Thus, capital assistance is another tool which thrift managers may utilize to ease the transition of their institutions into a deregulated environment.

As I indicated when I introduced the capital assistance and the revised regulators bill, these are short-term solutions to long-term problems. We stabilize and preserve the thrift industry by virtue of these bills. We should also insure the industry's long-term viability by expanding the investment and lending powers available to thrift institutions.

To ignore consideration of long-term solutions now will merely invite a reoccurrence of these capital assistance hearings during the next downturn.

Therefore, in considering the legislation before us, I urge my colleagues to keep in mind also the need to update the statutory framework under which depository institutions operate and compete.

[Copies of the two bills being considered follow:]

97TH CONGRESS
2D SESSION

S. 2531

To provide flexibility to the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation to deal with financially distressed institutions.

IN THE SENATE OF THE UNITED STATES

MAY 14 (legislative day, MAY 11), 1982

Mr. GARN (for himself, Mr. TOWER, Mr. HEINZ, and Mr. LUGAR) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To provide flexibility to the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation to deal with financially distressed institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Capital Assistance Act of 1982".

SEC. 2. (a) Section 406(f) of the National Housing Act (12 U.S.C. 1729(f)) is amended by adding at the end thereof the following:

"(4)(A) Notwithstanding any other provision of State or Federal law, and without limitation on any authority pro-

vided elsewhere in this Act or the Home Owners' Loan Act of 1933, the Corporation, in its sole discretion and on such terms and conditions as it may provide, is authorized to increase or maintain the capital of a qualified institution by making periodic purchases of capital instruments, as defined by the Corporation, for such form of consideration as the Corporation may determine, from such qualified institution, and may authorize such institution to issue such instruments, pursuant to this paragraph.

"(B) For the purposes of this paragraph, the term 'qualified institution' means an insured institution which, as determined by the Corporation—

"(i) has net worth equal to or less than 3 per centum of its assets;

"(ii) has incurred losses during the two previous quarters;

"(iii) agrees to comply with all the terms and conditions established by the Corporation for receiving assistance pursuant to this paragraph, including, without limitation on the totality of the foregoing, those relating to reporting, compliance with laws, rules and regulations, execution and implementation of resolutions and agreements to merge or reorganize, suspension of dividends by stock institutions, submission and adoption of plans of operation, restrictions on operations, repay-

ment of assistance received, and consent to supervisory action;

"(iv) will be solvent for more than six months, as determined by the Corporation in accordance with the methods for calculating net worth pursuant to this paragraph; and

"(v) has investments in residential mortgages or securities backed by such mortgages aggregating at least 20 per centum of its assets.

"(C) The Corporation may initially purchase capital instruments as follows:

"(i) With respect to a qualified institution having net worth greater than 2 per centum and less than or equal to 3 per centum, the Corporation may purchase capital instruments in any period from such institution in an amount equal to 30 per centum of its actual losses (not occasioned by mismanagement or speculation in futures or forward contracts), as determined by the Corporation.

"(ii) With respect to a qualified institution having net worth greater than 1 per centum and less than or equal to 2 per centum, the Corporation may purchase capital instruments in any period from such institution in an amount equal to 40 per centum of its actual losses (not occasioned by mismanagement or specula-

tion in futures or forward contracts), as determined by the Corporation.

"(iii) With respect to a qualified institution having net worth greater than zero and less than or equal to 1 per centum, the Corporation may purchase capital instruments in any period from such institution in an amount equal to 50 per centum of its actual losses (not occasioned by mismanagement or speculation in futures or forward contracts), as determined by the Corporation.

"(D) In the exercise of its authority under this paragraph, the Corporation may at any time, in its sole discretion, establish criteria which, with respect to ranges of net worth, calculation of losses, and percentage of losses to be met by purchases of capital instruments, differ from those set forth in subparagraph (C).

"(E) No assistance may be provided to a qualified institution pursuant to this paragraph if the Corporation determines that providing such assistance would be costlier than liquidating (including paying the insured accounts of) such institution or dealing with it in accordance with paragraph (1) or (2) of this subsection.

"(F) Notwithstanding any other provision of this paragraph, the Corporation shall in no period purchase capital instruments from a qualified institution in an amount equal to

more than 100 per centum of such institution's actual losses incurred for the immediately preceding period.

"(G) The provisions of the constitution or the laws, civil or criminal, of any State, express or implied, limiting the authority of a qualified institution (i) to take part in programs under this paragraph, (ii) to issue and otherwise deal in capital instruments issued pursuant to this paragraph, or (iii) to continue operations, including the receipt of deposits and the payment or crediting of interest or dividends to depositors, because of the level of such institution's net worth, surplus fund, or guaranty fund, shall not apply to any qualified institution which the Corporation has approved for the purpose of taking part in programs under this paragraph, continuing operations, or paying interest or dividends.

"(H) During any period when a qualified institution has outstanding capital instruments issued in accordance with this paragraph, such institution shall not be liable for any State or local tax which is determined on the basis of the deposits held by such institution or the interest paid thereon.

"(I) Notwithstanding any other Federal or State law, capital instruments purchased by the Corporation under this paragraph shall be deemed to be net worth for statutory and regulatory purposes.".

(b) Section 5(b)(5) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(b)(5)) is amended—

(1) by striking out subparagraph (B) and inserting in lieu thereof the following:

"(B) Capital instruments issued by an association pursuant to section 406(f) of the National Housing Act shall constitute part of the general reserves and net worth of the association, in accordance with the rules and regulations of the Board."; and

(2) by adding at the end thereof a new subparagraph (C) as follows:

"(C) The Board shall provide in its rules and regulations for charging losses to mutual capital certificates, capital instruments issued pursuant to section 406(f) of the National Housing Act, reserves, and other net worth accounts.".

(c) Section 403(b) of the National Housing Act (12 U.S.C. 1726(b)) is amended—

(1) in the fourth-to-last sentence by inserting after "items," the following: "including capital instruments issued pursuant to section 406(f) of this Act,"; and

(2) in the second-to-last sentence by striking out "the mutual capital certificate" and inserting in lieu thereof "mutual capital certificates, capital instruments issued pursuant to section 406(f) of the National Housing Act, as amended,".

SEC. 3. Section 13 of the Federal Deposit Insurance Act (12 U.S.C. 1823) is amended by adding at the end thereof the following:

"(h)(1) Notwithstanding any other provision of State or Federal law, and without limitation on any authority provided elsewhere in this Act the Corporation, in its sole discretion and on such terms and conditions as it may prescribe, is authorized to increase or maintain the capital of a qualified institution by making periodic purchases of capital instruments, as defined by the Corporation, for such form of consideration as the Corporation may determine, from such institution, and may authorize such institution to issue such instruments, pursuant to this subsection.

"(2) For the purpose of this subsection, the term 'qualified institution' means an insured bank which, as determined by the Corporation—

"(A) has net worth equal to or less than 3 per centum of its assets;

"(B) has incurred losses during the two previous quarters;

"(C) agrees to comply with all the terms and conditions established by the Corporation for receiving assistance pursuant to this subsection, including, without limitation on the totality of the foregoing, those relating to reporting, compliance with laws, rules and regu-

lations, execution and implementation of resolutions and agreements to merge or reorganize, suspension of dividends by stock institutions, submission and adoption of plans of operation, restrictions on operations, repayment of assistance received, and consent to supervisory action;

"(D) will be solvent for more than six months, as determined by the Corporation in accordance with the methods for calculating net worth pursuant to this subsection; and

"(E) has investments in residential mortgages or securities backed by such mortgages aggregating at least 20 per centum of its assets.

"(3) The Corporation may initially purchase capital instruments as follows:

"(A) With respect to a qualified institution having net worth greater than 2 per centum and less than or equal to 3 per centum, the Corporation may purchase capital instruments in any period from such institution in an amount equal to 30 per centum of the actual losses (not occasioned by mismanagement or speculation in futures or forward contracts), as determined by the Corporation.

"(B) With respect to a qualified institution having net worth greater than 1 per centum and less than or

equal to 2 per centum, the Corporation may purchase capital instruments in any period from such institution in an amount equal to 40 per centum of the actual losses (not occasioned by mismanagement or speculation in futures or forward contracts), as determined by the Corporation.

"(C) With respect to a qualified institution having net worth greater than zero and less than or equal to 1 per centum, the Corporation may purchase capital instruments in any period from such institution in an amount equal to 50 per centum of the actual losses (not occasioned by mismanagement or speculation in futures or forward contracts), as determined by the Corporation.

"(4) In the exercise of its authority under this subsection, the Corporation may at any time, in its sole discretion, establish criteria which, with respect to ranges of net worth, calculation of losses, and percentage of losses to be met by purchases of capital instruments, differ from those set forth in paragraph (3).

"(5) No assistance may be provided to a qualified institution pursuant to this subsection if the Corporation determines that providing such assistance would be costlier than liquidating (including paying the insured accounts of) such

institution or dealing with it in accordance with subsection (c) or (d) of this section.

"(6) Notwithstanding any other provision of this subsection, the Corporation shall in no period purchase capital instruments from a qualified institution in an amount equal to more than 100 per centum of such institution's actual losses incurred for the immediately preceding period.

"(7) The provisions of the constitution or the laws, civil or criminal, of any State, express or implied, limiting the authority of a qualified institution (A) to take part in programs under this subsection, (B) to issue and otherwise deal in capital certificates issued pursuant to this subsection, or (C) to continue operations, including the receipt of deposits and the payment or crediting of interest or dividends to depositors, because of the level of such institution's net worth, surplus fund, or guaranty fund, shall not apply to any qualified institution which the Corporation has approved for the purpose of taking part in programs under this subsection, continuing operations, or paying interest or dividends.

"(8) During any period when a qualified institution has outstanding capital instruments issued in accordance with this subsection, such institution shall not be liable for any State or local tax which is determined on the basis of the deposits held by such institution or the interest paid thereon.

"(9) Notwithstanding any other Federal or State law, capital instruments purchased by the Corporation under this subsection shall be deemed to be net worth for statutory and regulatory purposes.".

97TH CONGRESS
2D SESSION

S. 2532

To provide flexibility to the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and the Federal supervisory agencies to deal with financially distressed depository institutions.

IN THE SENATE OF THE UNITED STATES

MAY 14 (legislative day, MAY 11), 1982

Mr. GARN (by request) introduced the following bill, which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To provide flexibility to the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and the Federal supervisory agencies to deal with financially distressed depository institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—FEDERAL DEPOSIT INSURANCE CORPORATION AMENDMENTS

ASSISTANCE TO INSURED BANKS

SEC. 101. Section 13(c) of the Federal Deposit Insurance Act (12 U.S.C. 1823(c)) is amended to read as follows:

"(c)(1) The Corporation is authorized, in its sole discretion and upon such terms and conditions as the Board of Directors may prescribe, to make loans to, to make deposits in, to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured bank—

"(A) if such action is taken to prevent the closing of such insured bank;

"(B) if, with respect to a closed insured bank, such action is taken to restore such closed insured bank to normal operation; or

"(C) if, when severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources, such action is taken in order to lessen the risk to the Corporation posed by such insured bank under such threat of instability.

"(2)(A) In order to facilitate a merger or consolidation of an insured bank described in subparagraph (B) with an insured institution or the sale of assets of such insured bank and the assumption of such insured bank's liabilities by an insured institution, or the acquisition of the stock of such insured bank, the Corporation is authorized, in its sole discretion and upon such terms and conditions as the Board of Directors may prescribe—

"(i) to purchase any such assets or assume any such liabilities;

"(ii) to make loans or contributions to, or deposits in, or purchase the securities of, such insured institution or the company which controls or will acquire control of such insured institution;

"(iii) to guarantee such insured institution or the company which controls or will acquire control of such insured institution against loss by reason of such insured institution's merging or consolidating with or assuming the liabilities and purchasing the assets of such insured bank or by reason of such company acquiring control of such insured bank; or

"(iv) any combination of subparagraphs (i) through (iii).

"(B) An insured bank described in this paragraph (2)—

"(i) is an insured bank which is closed;

"(ii) is an insured bank which, in the judgment of the Board of Directors, is in danger of closing; or

"(iii) is an insured bank which, when severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial resources, is determined by the Corporation, in its sole discretion, to require assistance under subparagraph (A) in order to lessen the

risk to the Corporation posed by such insured bank under such threat of instability.

"(3) The Corporation may provide any person acquiring control of, merging with, consolidating with or acquiring the assets of an insured bank under section 13(f) of this Act with such financial assistance as it could provide an insured institution under this subsection.

"(4) No assistance shall be provided under this subsection in an amount in excess of that amount which the Corporation determines to be reasonably necessary to save the cost of liquidating (including paying the insured accounts of) such insured bank, except that such restriction shall not apply in any case in which the Corporation determines that the continued operation of such insured bank is essential to provide adequate banking services in its community.

"(5) Any assistance provided under this subsection may be in subordination to the rights of depositors and other creditors.

"(6) In its annual report to the Congress, the Corporation shall report the total amount it has saved, or estimates it has saved, by exercising the authority provided in this subsection.

"(7) For purposes of this subsection, the term 'insured institution' means an insured bank as defined in section 3 of

this Act or an insured institution as defined in section 401 of the National Housing Act (12 U.S.C. 1724).".

FEDERAL DEPOSIT INSURANCE CORPORATION—INSURED FEDERAL SAVINGS BANKS

SEC. 102. Section 5 of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464), is amended by adding at the end thereof the following:

"(p)(1) Notwithstanding any other provision of this section, the Board, subject to the provisions of this subsection, may authorize, under the rules and regulations of the Board, the conversion of a State-chartered savings bank insured by the Federal Deposit Insurance Corporation into a Federal savings bank, provided such conversion is not in contravention of State law, and provide for the organization, incorporation, operation, and regulation of such institution.

"(2)(A) The Federal Deposit Insurance Corporation shall insure the deposit accounts of any Federal savings bank chartered pursuant to this subsection, until such time as the accounts of such institution are insured by the Federal Savings and Loan Insurance Corporation.

"(B) The Board shall provide the Federal Deposit Insurance Corporation with notification of any application under this Act for conversion to a Federal charter by an institution insured by that Corporation, shall consult with said Corporation before disposing of the application, and shall pro-

vide said Corporation with notification of the Board's determination with respect to such application.

"(C) The Federal Deposit Insurance Corporation shall have the power to make special examinations of any Federal savings bank it insures and for which the Board of Directors of the Federal Deposit Insurance Corporation determines an examination is necessary to determine the condition of the bank for insurance purposes.

"(D) Except with the prior written approval of the Federal Deposit Insurance Corporation, no Federal savings bank insured by the Federal Deposit Insurance Corporation shall—

"(i) merge or consolidate with any bank, association, or institution that is not insured by the Federal Deposit Insurance Corporation;

"(ii) assume liability to pay any deposits made in, or similar liabilities of, any bank, association, or institution that is not insured by the Federal Deposit Insurance Corporation; or

"(iii) transfer assets to any bank, association, or institution that is not insured by the Federal Deposit Insurance Corporation in consideration of the assumption of liabilities for any portion of the deposits made in such bank.

(3) In granting any approval required by paragraph (1) of this subsection, the Board of Directors of the Federal Deposit Insurance Corporation shall consider the financial and managerial resources, and the future prospects of the existing and proposed institutions.

(4) Notwithstanding section 402(j) of the National Housing Act, or any provision of the constitution or laws of any State, or paragraph (1) of this subsection, if the Federal Deposit Insurance Corporation determines conversion into a Federal stock savings bank or the chartering of a Federal stock savings bank is necessary to prevent the closing of a savings bank it insures or to reopen a closed savings bank it insured, or if the Federal Deposit Insurance Corporation determines, with the concurrence of the Board, that severe financial conditions exist that threaten the stability of a savings bank insured by such Corporation and that such a conversion or charter is likely to improve the financial condition of such savings bank, the Federal Deposit Insurance Corporation shall provide to the Board a certificate of such determination, the reasons therefor and conformance with the requirements of this Act, and the bank, without further action by the Board, shall be converted or chartered by the Board, pursuant to the rules and regulations thereof, from the time the Federal Deposit Insurance Corporation issues such certificate.

"(3) A Federal savings bank chartered under this subsection shall have the same authority with respect to investments, operations, and activities, and shall be subject to the same restrictions, including those applicable to branching and discrimination, as would apply to it if it were chartered as a Federal savings bank under any other provision of this Act.

"(4) For purposes of the Bank Protection Act of 1968, the Home Mortgage Disclosure Act, the Community Reinvestment Act, the Depository Institution Management Interlocks Act, the Depository Institutions Deregulation Act of 1980, the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Debt Collection Practices Act, the Electronic Fund Transfer Act, and section 12(i) of the Securities Exchange Act of 1934, a Federal savings bank, the deposits of which are insured by the Federal Deposit Insurance Corporation, shall be regarded as an institution the accounts of which are insured by the Federal Savings and Loan Insurance Corporation.".

CONFORMING AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

SEC. 103. (a) Section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)) is amended—

(1) in paragraph (2) thereof, by striking out "and" at the end thereof;

(2) in paragraph (3) thereof, by striking out the period at the end thereof and inserting in lieu thereof "; and"; and

(3) by adding at the end thereof the following:

"(4) the Federal Home Loan Bank Board in the case of an insured Federal savings bank.".

(b) Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813) is amended by inserting at the end thereof the following:

"(t) The term 'insured Federal savings bank' means a Federal savings bank chartered pursuant to section 5(p) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(p)) and insured by the Corporation.".

(c) Section 4 of the Federal Deposit Insurance Act (12 U.S.C. 1814) is amended by inserting at the end thereof the following:

"(c) Every Federal savings bank which is chartered pursuant to section 5(p) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(p)), and which is engaged in the business of receiving deposits other than trust funds as herein defined, shall be an insured bank from the time it is authorized to commence business, until such time as its accounts are insured by the Federal Savings and Loan Insurance Corporation.".

(d) Section 7(a)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1817(a)(2)) is amended by inserting at the end thereof the following: "The Corporation shall have access to reports of examination made by, and reports of condition made to, the Federal Home Loan Bank Board or any Federal Home Loan Bank, respecting any insured Federal savings bank, and the Corporation shall have access to all revisions of reports of condition made to either of them, and they shall promptly advise the Corporation of any revisions or changes in respect to deposit liabilities made or required to be made in any report of condition.".

(e) Section 7(a)(3) of the Federal Deposit Insurance Act (12 U.S.C. 1817(a)(3)) is amended by revising the first sentence of the subsection to read as follows:

"(3) Each insured State nonmember bank (except a District bank) and each foreign bank having an insured branch (other than a Federal branch) shall make to the Corporation, each insured national bank, each foreign bank having an insured branch which is a Federal branch, and each insured District bank shall make to the Comptroller of the Currency, each insured State member bank shall make to the Federal Reserve bank of which it is a member, and each insured Federal savings bank shall make to the Federal Home Loan Bank Board, four reports of condition annually upon dates which shall be selected by the Chairman of the Board of Di-

rectors, the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Federal Home Loan Bank Board.".

(f) Section 7(a)(6) of the Federal Deposit Insurance Act (12 U.S.C. 1817(a)(6)) is amended by inserting ", the Federal Home Loan Bank Board" after "Comptroller of the Currency" and before the word "and" the first place it appears.

(g) Section 8(a) of the Federal Deposit Insurance Act (12 U.S.C. 1818(a)) is amended by—

(1) inserting in the second sentence thereof, after the words "district bank,", the following: "to the Federal Home Loan Bank Board in the case of an insured Federal savings bank,"; and

(2) inserting in the third sentence thereof, after the words "national bank,", the following: "or the Federal Home Loan Bank Board in the case of an insured Federal savings bank,".

(h) Section 8(o) of the Federal Deposit Insurance Act (12 U.S.C. 1818(o)) is amended by inserting at the end thereof the following: "Whenever the insured status of an insured Federal savings bank shall be terminated by action of the Board of Directors, the Federal Home Loan Bank Board shall appoint a receiver for the bank, which shall be the Corporation.".

(i) Section 10(b) of the Federal Deposit Insurance Act (12 U.S.C. 1820(b)) is amended by inserting in the second sentence thereof, after the words "or District bank,", the following: "or any insured Federal savings bank,".

(j) Section 11(c) of the Federal Deposit Insurance Act (12 U.S.C. 1821(c)) is amended by inserting at the end thereof the following: "Notwithstanding any other provision of law, whenever the Federal Home Loan Bank Board shall appoint a receiver, other than a conservator, of any insured Federal savings bank hereafter closed, it shall appoint the Corporation receiver for such closed bank.".

(k) Section 11(g) of the Federal Deposit Insurance Act (12 U.S.C. 1821(g)) is amended by inserting in the first sentence thereof, after the words "District bank,", the following: "or closed insured Federal savings bank,".

(l) Section 12(a) of the Federal Deposit Insurance Act (12 U.S.C. 1822(a)) is amended by inserting, after the words "foreign bank,", the following: "insured Federal savings bank,".

(m) Section 13 of the Federal Deposit Insurance Act (12 U.S.C. 1823) is amended—

(1) by redesignating subsections (f) and (g) as subsections (g) and (h), respectively; and

(2) in subsection (e)—

(A) by inserting "(e)" before "No agreement"; and

(B) by striking out the first paragraph of such subsection.

(n) Section 18(c) of the Federal Deposit Insurance Act (12 U.S.C. 1828(c)) is amended by inserting at the end thereof the following:

"(12) The provisions of this subsection do not apply to any merger transaction involving an insured Federal savings bank unless the resulting institution will be an insured bank other than an insured Federal savings bank.".

(o) Section 18(j) of the Federal Deposit Insurance Act (12 U.S.C. 1828(j)) is amended by adding a new paragraph (4), to read as follows:

"(4) The provisions of this subsection shall not apply to an insured Federal savings bank.".

(p) Section 26 of the Federal Deposit Insurance Act (12 U.S.C. 1831(c)) is amended as follows:

(1) By adding "(a)" at the beginning thereof and adding a new last sentence to read as follows: "The provisions of this subsection shall apply only to mergers, consolidations or conversions consummated and effective prior to the effective date of this amendment."; and

(2) By adding a new subsection (b) to read as follows:

"(b) No transaction involving a change of deposit insurance agencies from the Corporation to the Federal Savings and Loan Insurance Corporation shall be deemed a termination of insured status under section 8(a) of this Act.".

(q) Section 7(j)(16) of the Federal Deposit Insurance Act (12 U.S.C. 1817(j)(16)) is amended by adding the following sentence: "This subsection shall not apply to an insured Federal savings bank.".

CONFORMING AMENDMENTS TO THE HOME OWNERS' LOAN ACT OF 1933

SEC. 104. (a) Section 2(d) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1462(d)), is amended to read as follows:

"(d) The term 'association' means a Federal savings and loan association or a Federal savings bank chartered by the Board under section 5 of this Act and any reference in any other law to a Federal savings and loan association shall be deemed to be also a reference to such Federal savings banks, unless the context indicates otherwise.".

(b) Section 5(d)(6) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464(d)(6)), is amended as follows:

(1) By inserting in paragraph (B), after the words "Federal Savings and Loan Insurance Corporation", the words "or the Federal Deposit Insurance Corporation".

(2) By inserting in the second sentence of paragraph (D), after the words "shall appoint", the words "(except as hereafter provided)"; and

(3) By inserting at the end of paragraph (D): "In the case of a Federal savings bank chartered pursuant to subsection (p) and insured by the Federal Deposit Insurance Corporation the Board shall appoint only the Federal Deposit Insurance Corporation as receiver for the association and the Federal Deposit Insurance Corporation shall have the same powers as receiver as those granted by this paragraph to the Federal Savings and Loan Insurance Corporation as receiver of other associations.".

(c) Section 5(d)(11) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464(d)(11)), is amended by striking the words "with other", and substituting therefor the words "with associations or with any".

CONFORMING AMENDMENTS TO THE NATIONAL HOUSING ACT

SEC. 105. (a) Section 403(a) of the National Housing Act, as amended (12 U.S.C. 1726(a)), is amended to read as follows:

"(a) It shall be the duty of the Corporation to insure the accounts of all Federal savings and loan associations, and all Federal savings banks, except for Federal savings banks the deposits of which are insured by the Federal Deposit Insurance Corporation, and it may insure the accounts of building and loan, savings and loan, and homestead associations and cooperative banks organized and operated according to the laws of the State, District, territory, or possession in which they are chartered or organized, and of savings banks chartered pursuant to section 5(p) of the Home Owners' Loan Act of 1933, as amended.".

(b) Section 408(a)(1) (A) and (B) of the National Housing Act, as amended (12 U.S.C. 1730(a)(1)), are amended to read as follows:

"(A) 'insured institution' means a Federal savings and loan association, a Federal savings bank, a building and loan, savings and loan or homestead association or a cooperative bank, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation, and shall include a Federal savings bank

the deposits of which are insured by the Federal Deposit Insurance Corporation;

"(B) 'uninsured institution' means any association or bank referred to in subparagraph (A) hereof, the accounts of which are not insured by the Federal Savings and Loan Insurance Corporation, except for a Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation;".

(c) Section 407(m) of the National Housing Act, as amended (12 U.S.C. 1730(m)), is amended by adding a new paragraph (4), to read as follows:

"(4) The Federal Home Loan Bank Board, or its designated representative, shall have the same power with respect to a Federal association (or affiliate thereof) the deposits of which are insured by the Federal Deposit Insurance Corporation as it or the Corporation has under paragraphs (1) and (2) of this subsection with respect to insured institutions (or their affiliates).".

(d) Section 407(l)(6) of the National Housing Act, as amended (12 U.S.C. 1730(l)(6)), is amended by adding the following sentence: "For the purposes of this subsection the term 'insured institution' shall include a Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation.".

(e) Section 407(q)(13) of the National Housing Act, as amended (12 U.S.C. 1730(q)(13)), is amended by adding the following sentence: "For the purposes of this subsection, the term 'insured institution' shall include a Federal savings bank the deposits of which are insured by the Federal Deposit Insurance Corporation.".

EXTRAORDINARY ACQUISITIONS

SEC. 106. Section 13 of the Federal Deposit Insurance Act (12 U.S.C. 1823) is amended by inserting after subsection (e) thereof the following:

"(f)(1) Nothing contained in paragraphs (2) or (3) shall be construed to limit the Corporation's powers in subsection (c) to assist a transaction under paragraphs (2) or (3).

"(2)(A) Whenever an insured bank with total assets of $500,000,000 or more (as determined from its most recent report of condition) is closed, the Corporation, as receiver, may, in its discretion and upon such terms and conditions as it may determine, and with such approvals as may otherwise be lawfully required by any court or any State or Federal supervisory agency affecting its chartered bank, sell assets of the closed bank to and arrange for the assumption of the liabilities of the closed bank by an insured depository institution located in the State where the closed bank was chartered but established by an out-of-State bank or holding company.

"(B) In determining whether to arrange a sale of assets and assumption of liabilities of a closed insured bank under the authority of this paragraph (2), the Corporation may solicit such offers as are practicable from any prospective purchaser it determines, in its sole discretion, is both qualified and capable of acquiring the assets and liabilities of the closed bank.

"(C) In making a determination to solicit offers under subparagraph (B), the Corporation shall consult the State bank supervisor of the State in which the closed insured bank was chartered. The State bank supervisor shall be given a reasonable opportunity, and in no event less than twenty-four hours, to object to the use of the provisions of this paragraph (2). Such notice may be provided by the Corporation prior to its appointment as receiver, but in anticipation of an impending appointment. If the State supervisor objects, the Corporation may use the authority of this paragraph (2) only by a unanimous vote of the Board of Directors. The Board of Directors shall provide to the State supervisor, as soon as practicable, a written certification of its determination.

"(3)(A) Whenever the Corporation has determined, in its discretion, that an insured bank with total assets of $500,000,000 or more (as determined from its most recent report of condition) is in danger of closing, then, with such approvals as may otherwise be lawfully required by any ap-

propriate supervisory agency respecting its chartered bank, the insured bank may merge with or its assets may be purchased by and its liabilities assumed by an insured depository institution located in the State where the insured bank is chartered but established by an out-of-State bank or holding company or its stock may be acquired by an out-of-State bank or holding company.

"(B) The Corporation may make a determination under paragraph (A) only where the board of directors (or board of trustees) of the insured bank and the appropriate Federal or State chartering authority have specified in writing that the bank is in danger of closing and have requested in writing that the Corporation assist a merger or a purchase.

"(C) Before making a determination under subparagraph (A), if the bank is not State-chartered, the Corporation shall consult the State bank supervisor of the State in which the bank in danger of closing is chartered. The State bank supervisor shall be given a reasonable opportunity, and in no event less than twenty-four hours, to object to the use of the provisions of this paragraph (3). If the State supervisor objects, the Corporation may use the authority of this paragraph (3) only by a unanimous vote of the Board of Directors. The Board of Directors shall provide to the State supervisor, as soon as practicable, a written certification of its determination.

"(4) Notwithstanding subsection (d) of section 3 of the Bank Holding Company Act of 1956 or any other provision of law, State or Federal, or the constitution of any State, an institution that merges with or acquires an insured bank under paragraphs (2) or (3) is authorized to be and shall be operated as a subsidiary of the out-of-State bank or holding company; except that an out-of-State bank may operate the resulting institution as a subsidiary only if such ownership is otherwise specifically authorized.

"(5) No sale may be made under the provisions of paragraphs (2) or (3)—

"(i) which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States; or

"(ii) whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless the Corporation finds that the anticompetitive effects of the proposed transactions are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

"(6) As used in this subsection—

"(i) the term 'receiver' shall mean the Corporation when it has been appointed the receiver of a closed insured bank;

"(ii) the term 'insured depository institution' shall mean an insured bank or an association or bank insured by the Federal Savings and Loan Insurance Corporation; and

"(iii) the term 'out-of-State bank or holding company' shall mean an insured bank having its principal place of banking business in a State other than the State in which the closed bank or the bank in danger of closing was chartered or a company that is not otherwise operating an insured depository institution subsidiary in the State in which the closed bank or the bank in danger of closing was chartered.".

ASSESSMENTS

SEC. 107. The third sentence of section 7(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(d)(1)) is amended—

(1) by striking out "and" before "(3) the insurance losses"; and

(2) by inserting before the period at the end thereof the following: "; and (4) any lending costs for the calendar year, which costs shall be equal to the amount by which the amount of interest earned, if any,

from each loan made by the Corporation under section 13 of this Act after January 1, 1982, is less than the amount which the Corporation would have earned in interest for the calendar year if interest had been paid on such loan during such calendar year at a rate equal to the average current value of funds to the United States Treasury for such calendar year.".

WAIVER OF NOTICE REQUIREMENTS

SEC. 108. (a) Section 4(c)(8) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(8)) is amended by striking out the semicolon at the end thereof and inserting in lieu thereof the following: ". Notwithstanding any other provision of this Act, if the Board finds that an emergency exists which requires it to act immediately on any application under this subsection involving a thrift institution, and the primary Federal regulator of such institution concurs in such finding, the Board may dispense with the notice and hearing requirement of this subsection and the Board may approve or deny any such application without notice or hearing;".

(b) Section 2(i) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(i)) is amended by—

(1) striking out "or" before "(3)"; and

(2) by inserting before the period at the end thereof the following: "or (4) a Federal savings bank."

(c) The first sentence of section 3(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(d)) is amended by inserting after "no application" the following: "(except an application filed as a result of a transaction authorized under section 13(f) of the Federal Deposit Insurance Act (12 U.S.C. 1823(f)))".

TITLE II—FEDERAL HOME LOAN BANK BOARD AMENDMENTS

FEDERAL STOCK SAVINGS INSTITUTIONS

SEC. 201. (a) Section 5 of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464), is amended by adding at the end thereof the following:

"(o) Notwithstanding any other provision of Federal law or the laws or constitution of any State, and consistent with the purposes of this Act, the Board may authorize (or in the case of a Federal association, require) the conversion of a mutual savings and loan association or Federal mutual savings bank that is insured by the Federal Savings and Loan Insurance Corporation into a Federal stock savings and loan association or Federal stock savings bank, or charter a Federal stock savings and loan association or Federal stock savings bank to acquire the assets of, or merge with such a mutual institution under the rules and regulations of the Board. Authorizations under this subsection may be made only to assist an institution in receivership, or if the Board

has determined that severe financial conditions exist which threaten the stability of an institution and that such authorization is likely to improve the financial condition of the institution, or when the Federal Savings and Loan Insurance Corporation has contracted to provide assistance to such institution under section 406 of the National Housing Act. A Federal savings bank chartered under this subsection shall have the same authority with respect to investments, operations and activities, and shall be subject to the same restrictions, including those applicable to branching and discrimination, as would apply to it if it were chartered as a Federal savings bank under any other provisions of this Act, and may engage in any investment, activity, or operation that the institution it acquired was engaged in if that institution was a Federal savings bank, or would have been authorized to engage in had that institution converted to a Federal charter.".

ASSISTANCE TO THRIFT INSTITUTIONS

SEC. 202. (a) Section 406(f) of the National Housing Act (12 U.S.C. 1729(f)) is amended to read as follows:

"(f)(1) The Corporation is authorized, in its sole discretion and upon such terms and conditions as the Corporation may prescribe, to make loans to, to make deposits in, to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured institution—

"(A) if such action is taken to prevent the default of such insured institution;

"(B) if, with respect to an insured institution in default, such action is taken to restore such insured institution in default to normal operation; or

"(C) if, when severe financial conditions exist which threaten the stability of a significant number of insured institutions or of insured institutions possessing significant resources, such action is taken in order to lessen the risk to the Corporation posed by such insured institution under such threat of instability.

"(2)(A) In order to facilitate a merger or consolidation of an insured institution described in subparagraph (B) with another insured institution or the sale of assets of such insured institution and the assumption of such insured institution's liabilities by another insured institution, the Corporation is authorized, in its sole discretion and upon such terms and conditions as the Corporation may prescribe—

"(i) to purchase any such assets or assume any such liabilities;

"(ii) to make loans or contributions to, or deposits in, or purchase the securities of, such other insured institution (which, for the purposes of this subparagraph, shall include a Federal savings bank insured by the Federal Deposit Insurance Corporation); or

"(iii) to guarantee such other insured institution (which, for the purposes of this subparagraph, shall include a Federal savings bank insured by the Federal Deposit Insurance Corporation) against loss by reason of such other insured institution's merging or consolidating with or assuming the liabilities and purchasing the assets of such insured institution.

"(B) An insured institution described in this subparagraph—

"(i) is an insured institution which is in default;

"(ii) is an insured institution which, in the judgment of the Corporation is in danger of default; or

"(iii) is an insured institution which, when severe financial conditions exist which threaten the stability of a significant number of insured institutions, or of insured institutions possessing significant financial resources, is determined by the Corporation, in its sole discretion, to require assistance under subparagraph (A) in order to lessen the risk to the Corporation posed by such insured institution under such threat of instability.

"(3) The Corporation may provide any person acquiring control of, merging with, consolidating with or acquiring the assets of an insured institution under section 408(m) of this

Act with such financial assistance as it could provide an insured institution under this subsection.

"(4) No assistance shall be provided under paragraphs (1), (2), or (3) of this subsection in an amount in excess of that amount which the Corporation determines to be reasonably necessary to save the cost of liquidating (including paying the insured accounts of) such insured institution, except that such restriction shall not apply in any case in which the Corporation determines that the continued operation of such insured institution is essential to provide adequate savings or home financing services in its community.".

(b) Section 406(b) of the National Housing Act (12 U.S.C. 1729(b)) is amended to read as follows:

"(b)(1) In the event that a Federal savings and loan association is in default, the Corporation shall be appointed as conservator or receiver and as such—

"(A) is authorized—

"(i) to take over the assets of and operate such association;

"(ii) to take such action as may be necessary to put it in a sound and solvent condition;

"(iii) to merge it with another insured institution;

"(iv) to organize a new Federal association to take over its assets;

"(i) to proceed to liquidate its assets in an orderly manner, or

"(ii) to make such other disposition of the matter as it deems appropriate

whichever it deems to be in the best interest of the association, its savers, and the Corporation; and

"(B) shall pay all valid credit obligations of the association.

"(2) The Corporation shall pay insurance as provided in *section 405. The surrender and transfer to the Corporation of an insured account in any such association which is in default shall subrogate the Corporation with respect to such insured account, but shall not affect any right which the insured member may have in the uninsured portion of his account or any right which he may have to participate in the distribution of the net proceeds remaining from the disposition of the assets of such association.".*

(c) Section 408(e) of the National Housing Act, as amended (12 U.S.C. 1730(e)) is amended by striking the phrase "savings and loan" wherever it appears.

(d) Section 408(e)(1) of the National Housing Act, as amended (12 U.S.C. 1730(e)(1)), is amended by adding the letter "(A)" immediately after the phrase "(e)(1)", and by [illegible] a new subparagraph (B), to read as follows:

"(B) Notwithstanding any provision of the constitution or laws of any State, or of this section, in the event the Federal Home Loan Bank Board determines that any of the grounds specified in section 5(d)(6)(A)(i), (ii), or (iii) of the Home Owners' Loan Act of 1933 exist with respect to an insured institution, other than a Federal association, the Board shall have exclusive power and jurisdiction to appoint the Corporation as sole conservator or receiver of such institution. In such cases the Corporation shall have the same powers and duties with respect to insured institutions as are conferred upon it under subsection (b) of this section with respect to Federal associations.".

(e) Section 406(c)(2) of the National Housing Act, as amended (12 U.S.C. 1729(c)(2)), is amended by adding the words "conservator or" immediately after the word "sole" in the first sentence.

(f) Section 406(c)(3) of the National Housing Act, as amended (12 U.S.C. 1729(c)(3)), is amended as follows:

(1) By adding the phrase "conservator or" immediately prior to the word "receiver" wherever it appears therein;

(2) By striking the phrase "paragraph (2)" and substituting therefor the phrase "paragraphs (1) or (2)"; and

(2) By striking the second sentence thereof.

(g) Section 406(d) of the National Housing Act, as amended (12 U.S.C. 1729(d)), is amended to read as follows:

"(d) In connection with the liquidation of insured institutions, the Corporation shall have power to carry on the business of and to collect all obligations to the insured institutions, to settle, compromise, or release claims in favor of or against the insured institutions, and to do all other things that may be necessary in connection therewith, subject only to the regulation of the Federal Home Loan Bank Board, or, in cases where the Corporation has been appointed conservator, receiver, or legal custodian solely by a public authority having jurisdiction over the matter other than said Board, subject only to the regulation of such public authority.".

EMERGENCY THRIFT ACQUISITIONS

SEC. 203. (a) Section 408 of the National Housing Act, as amended (12 U.S.C. 1730(a)), is amended by adding a new subsection (m), as follows:

"(m) Notwithstanding any provision of the laws or constitution of any State or any provision of Federal law, except as provided in subsections (e) (2) and (1) hereof, and in the third sentence of this subparagraph, the Corporation, upon its determination that severe financial conditions exist which threaten the stability of a significant number of insured institutions or of insured institutions possessing significant finan-

cial resources, may authorize, in its discretion and where it determines such authorization would lessen the risk to the Corporation, an insured institution that is eligible for assistance pursuant to section 406(f) of this Act to merge or consolidate with, or to transfer its assets and liabilities to, any other insured institution or any insured bank (as that term 'insured bank' is defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)), may authorize any other insured institution to acquire control of said insured institution, or may authorize any company to acquire control of said insured institution or to acquire the assets or assume the liabilities thereof. Mergers, consolidations, transfers, and acquisitions under this subsection shall be on such terms as the Corporation shall provide. Where otherwise required by law, transactions under this subsection must be approved by the primary Federal supervisor of the party thereto that is not an insured institution. In considering authorizations under this subsection, the need to minimize financial assistance required of the Corporation shall be the paramount consideration, but the Corporation shall make a reasonable effort to authorize transactions under this subsection in the following sequence: First, between institutions of the same type within the same State; second, between institutions of the same type in different States; third, between institutions of different types in the same State; and fourth, between institu-

tions of different types in different States. As used herein, the term type shall refer to the purpose of the organizations and the general nature of their powers rather than to the identity of the charterers of their form of corporate organization.".

(b) Section 408(e)(2) of the National Housing Act, as amended (12 U.S.C. 1730a(e)(2)), is amended as follows:

(1) By adding in the first sentence immediately after the term "subsection" the following: ", or any transaction under subsection (m) hereof,"; and

(2) By adding in the third sentence thereof immediately after the word "acquisition," the following: "except a transaction under subsection (m) hereof,".

ASSISTANCE TO FEDERAL HOME LOAN BANK MEMBERS

SEC. 204. Section 16 of the Federal Home Loan Bank Act (12 U.S.C. 1436) is amended by inserting "(a)" after "SEC. 16." and by adding at the end thereof the following:

"(b) Notwithstanding subsection (a) or any other provision of this Act, if the Board determines that severe financial conditions exist threatening the stability of member institutions, the Board may suspend temporarily the requirements of subsection (a) that a portion of net earnings be set aside semiannually by each Federal Home Loan Bank to a reserve account and permit each Federal Home Loan Bank to declare any pay dividends out of undivided profits.".

BORROWING AUTHORITY

SEC. 205. (a) The first sentence of section 402(d) of the National Housing Act (12 U.S.C. 1725(d)) is amended by inserting before the period at the end thereof the following: ", except that interest on loans from the Federal Home Loan Banks shall be not less than their current marginal cost of funds, taking into account the maturities involved, and loans from the Federal Home Loan Banks shall be adequately secured, as determined by the Board".

(b) The first sentence of section 402(i) of the National Housing Act (12 U.S.C. 1725(i)) is amended—

(1) by striking out "any other source" and inserting in lieu thereof "any source other than the Federal Home Loan Banks";

(2) by inserting "from the Treasury" after "*Provided*, That each such loan".

(c) Section 11 of the Federal Home Loan Bank Act (12 U.S.C. 1431) is amended by adding at the end thereof the following:

"(k) The Federal Home Loan Banks are hereby authorized, as directed by the Board, to make loans to the Federal Savings and Loan Insurance Corporation. All such loans shall be made in accordance with the provisions of section 402(d) of the National Housing Act.".

INSURANCE FUND RESERVES

SEC. 206. Section 404 of the National Housing Act, as amended (12 U.S.C. 1727), is amended by redesignating subsection (h) as subsection (i) and adding a new subsection (h), as follows:

"(h) Notwithstanding any other provision of this section, the Corporation, upon its determination that extraordinary financial conditions exist increasing the risk to the Corporation, may terminate distribution of shares of the secondary reserve and utilize said reserve on the same basis as the primary reserve. If otherwise authorized, the Corporation may resume such distribution upon its determination that said conditions no longer exist.".

FEDERAL HOME LOAN BANK ACT

SEC. 207. Section 17(a) of the the Federal Home Loan Bank Act, as amended (12 U.S.C. 1437(a)), is amended by adding a new sentence immediately after the first sentence, to read as follows: "Notwithstanding any other provision of law, the Board may from time to time make such provision as it deems appropriate authorizing the performance by any officer, employee, agent, or adminstrative unit thereof of any function of the Board (including any function of the Federal Savings and Loan Insurance Corporation), except with regard to promulgation of rules and regulations in accordance

with the Administrative Procedure Act, and adjudications subject to such Act.".

ATTORNEYS' FEES

SEC. 208. Section 5(d)(8)(A) of the Home Owners' Loan Act of 1933, as amended (12 U.S.C. 1464(d)(8)(A)), is amended by adding in the last sentence thereof, immediately after the word "party", the following: ", which prevails,".

CONTINUATION OF INSURANCE

SEC. 209. Section 405(a) of the National Housing Act, as amended (12 U.S.C. 1728(a)), is amended by adding after the first sentence the following: "Whenever the liabilities of an insured institution for accounts shall have been assumed by another insured institution or institutions, whether by way of merger, consolidation, or other statutory assumption, or pursuant to contract, all accounts so assumed shall have separate insurance which shall terminate at the end of six months from the date such assumption takes effect or, in the case of any certificate account, the earliest maturity date after the six-month period.".

TITLE III—NATIONAL CREDIT UNION ADMINISTRATION AMENDMENTS

ASSISTANCE TO CREDIT UNIONS

SEC. 301. Section 203 of the Federal Credit Union Act (12 U.S.C. 1783) is amended—

(1) in subsection (e), by inserting "from the Secretary of the Treasury" after "So long as any loans"; and

(2) by adding at the end thereof the following:

"(f) In addition to the authority to borrow from the Secretary of the Treasury provided in subsection (d), if, in the judgment of the Board, a loan to the fund is required at any time for carrying out the provisions of this title, the fund is authorized to borrow from the National Credit Union Administration Central Liquidity Facility.".

CREDIT UNION MERGERS

SEC. 302. Section 205 of the Federal Credit Union Act (12 U.S.C. 1785) is amended by adding at the end thereof the following:

"(h) Notwithstanding any other provision of law, the Board may authorize a merger or consolidation of an insured credit union which is insolvent or is in danger of insolvency with any other insured credit union or may authorize an insured credit union to purchase any of the assets of, or assume any of the liabilities of, any other insured credit union, which is insolvent or in danger of insolvency if the Board is satisfied that—

"(1) an emergency requiring expeditious action exists with respect to such other insured credit union;

"(2) other alternatives are not reasonably available; and

"(3) the public interest would best be served by approval of such merger, consolidation, purchase, or assumption.

"(i)(1) Notwithstanding any other provision of this Act or of State law, the Board may authorize an institution whose deposits or accounts are insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation to purchase any of the assets of or assume any of the liabilities of an insured credit union which is insolvent or in danger of insolvency, except that prior to exercising this authority the Board must attempt to effect the merger or consolidation of an insured credit union which is insolvent or in danger of insolvency with another insured credit union, as provided in subsection (h).

"(2) For purposes of the authority contained in paragraph (1), insured accounts of the credit union may upon consummation of the purchase and assumption be converted to insured deposits or other comparable accounts in the acquiring institution, and the Board and the National Gredit Union Share Insurance Fund shall be absolved of any liability to the credit union's members with respect to those accounts.".

CENTRAL LIQUIDITY FACILITY ADVANCES

SEC. 303. Section 307(a) of the Federal Credit Union Act (12 U.S.C. 1795f(a)) is amended—

(1) in paragraph (15) thereof, by striking out "and" at the end thereof;

(2) in paragraph (16) thereof, by striking out the period at the end thereof and inserting in lieu thereof "; and"; and

(3) by adding at the end thereof the following:

"(17) advance funds to the National Credit Union Share Insurance Fund under such terms and conditions as may be established by the Board.".

TITLE IV—EFFECTIVE DATE AND SHORT TITLE

SEC. 401. The amendments made by this Act shall be effective on the date of the enactment of this Act.

SEC. 402. This Act may be cited as the "Deposit Insurance Flexibility Act".

The CHAIRMAN. Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman.

Let me begin by congratulating you, Mr. Chairman, on holding these hearings today and tomorrow on the legislative steps that are needed to support thrift institutions during a period in which economic circumstances have made many of them extremely vulnerable. Thrift institutions are in a great deal of difficulty today, to a large extent because they fulfill their public responsibilities too well by providing a stable source of low-cost long-term financing to the homeowners' market. The principal benefits of thrift financing have been an enormous success, supporting the highest incidence of homeownership in the world, yet it is precisely these long-term, low-yielding mortgage assets that have resulted in the thrifts running negative earnings during a sustained period of high interest rates, where they have had to pay more for short-term deposits than they, of course, can earn on their long-term loans.

The problems of the thrift industry caused by high-interests rates are severe. Over 90 percent of the savings and loan associations in the country are losing money. In 1981, the return on assets of the savings and loan industry was a negative 0.75 percent. Some 400 savings and loans are projected to reach a zero net worth by the end of this year and an additional 500 institutions by the end of 1983. That means roughly 900 institutions at zero net worth out of a total of 3,700. So even if interest rates were to decline the thrift industry would still be in a weakened net worth position and highly vulnerable.

Mr. Chairman, in my opinion, the problems of the thrift industry are the most important issues that we face in the Banking Committee between now and the end of this session of Congress. There is no question in my mind that the industry is in desperate need of assistance with interest to avert serious problems in the thrift industry. Orderly financial markets, public confidence in insured financial institutions and a stable source of institutional lending to the home mortgage industry demand that we take action. I believe there is a consensus in both Houses of Congress on the need to provide capital maintenance assistance to the thrift industry, in order to tide them over what we hope will be a temporary period of high industry rates. Indeed, many community-oriented commercial banks that are financing small business and agriculture may need such assistance also to alleviate the problems caused by high interest rates.

I think we need to clearly state that by far most of the institutions suffering with deficiencies are victims of high interest rates and not mismanagement or unsound practices or outright fraud, but net worth assistance to these institutions needs to be structured so that the real cause of the problem, high interest rates, is addressed. We need to take care not to create disincentives to efficient operation or the need to cut costs, nor should we place unmanageable administrative burdens on the regulatory agencies. Management needs to be permitted to structure merger programs that best suit the marketplace.

We owe a debt of gratitude to the chairman for introducing S. 2531 and S. 2532, which lay out the issues upon which we are to focus in these hearings. S. 2531 provides for schedule of partial net worth assistance to both thrifts and banks whose net worth falls below 3 percent. Whether a more precise foundation of net worth maintenance would better serve the needs of maintaining a stable thrift industry will be the source of intensive scrutiny by these hearings as well as standards for agency mergers of institutions which are not characterized by mismanagement.

S. 2532 provides authority for the agencies to merge banks having difficulty across State lines and establishes conditions for the acquisition of thrifts by other thrifts, bank holding companies and other corporations within a State and across State lines.

There two bills include fundamental issues concerning the place in our financial system of specialized home financing institutions and the laws relating to deposit taking across State lines. The problems of the insured financial institutions caused by high interest rates require us to consider these issues in a straightforward matter. To avoid our responsibility will mean that action will be taken by the regulatory agencies without the support, the important support, I might emphasize, of congressional consensus.

So, successfully resolving the immediate problems of the thrift industry must be the No. 1 priority of this committee, and I look forward to cooperating with all members of the committee to achieve legislation which can become law, hopefully, before the end of June. If we do this, I think the country and the public will be well served.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Riegle. Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Thank you, Mr. Chairman.

I am pleased to be here this morning, but I am also sorry that I have to be here. I wish our Nation's thrifts had not lost $5 billion last year, I wish their financial situation was such that we would not be required to be there.

However, the economic position of the thrift industry is deteriorating so it is necessary for me, for all of us, to be here. I should note as we begin that we are not here today to talk about bailing out an industry that has gotten into trouble through its own mistakes. Rather, the industry is in trouble because it did precisely what the Federal Government told it to so—lend long and borrow short.

Th[illegible] which was so suc[illegible]ful in the past, and which [illegible] important role in m[illegible]ing it possible for the ordi[illegible] A[illegible] to [illegible] his own [illegible], has become a recipe for fi[illegible] trou[illegible] in t[illegible] difficult ec[illegible]omic times. Since federally imp[illegible] it dif[illegible] for thrifts to respond to the [illegible], I believe the Federal Gov[illegible] [illegible] thrifts with the [illegible]

[illegible] sup[illegible] [illegible]rifts to help [illegible] up t[illegible] [illegible]e, we help not

only the thrifts but also the housing industry, the lumber industry, the furniture and fixture industries, and all those who are dependent on the thrifts' ability to supply housing capital.

I think this assistance, and the necessary tools contained in the regulators bill should be enacted promptly. We cannot afford to delay.

I think we should work rapidly to resolve the differences between the approach to capital assistance taken by Senator Garn and the proposal offered by Congressman St Germain. I look forward to the comments of the witnesses today on the two alternative approaches.

I think we must also move forward in other areas. I believe we must address the regulatory issues if we want all our depository institutions to stay competitive in this rapidly changing economic environment. Many of the regulatory issues, however, are very controversial, and I hope we will not allow controversies which cannot be quickly resolved to delay action necessary to provide short-term capital assistance to thrifts which need it so badly.

The CHAIRMAN. Thank you, Senator Dixon.

Our first panel today is a very distinguished group:

The Honorable Preston Martin, Vice Chairman of the Federal Reserve Board;

The Honorable Richard T. Pratt, Chairman of the Federal Home Loan Bank Board;

The Honorable William M. Isaac, Chairman of the Federal Deposit Insurance Corporation; and

The Honorable C. Todd Conover, Comptroller of the Currency.

Gentlemen, we are happy to have you before us to testify on this legislation this morning.

Mr. Martin, I turn to you for your testimony first.

STATEMENT OF PRESTON MARTIN, VICE CHAIRMAN, FEDERAL RESERVE BOARD

Mr. MARTIN. Thank you, Mr. Chairman.

I am pleased to appear before you today, to comment on these two bills from the point of view of the Federal Reserve Board.

Our Board welcomes Senate consideration of the issues raised by these two interrelatod bills. We support their objectives, and we urge prompt Senate action to increase the ability of the agencies to address the current financial problems facing the nation's thrift institutions.

The chairman has very well outlined the circumstances which have brought the thrift industry to its present status.

Their problems reflect the general conditions of the economy, as has been mentioned, as well as the long-run effects of public policies that have required portfolio concentration by thrifts in fixed-rate, long-term residential mortgages. These problems reflect this, rather than endemic poor management.

The Board's view is that disinflationary policies will continue to succeed, contributing to lower and more stable interest rates and a reversal of the pressure on thrift earnings and capital. The run-off of older portfolio assets and the growing use of alternative mortgage instruments will also work to improve earnings and capital.

In the interim, however, special measures are required to bridge the gap until more normal operating conditions prevail.

During this transition period, the regulatory agencies need the tools to support those institutions with sound assets and satisfactory prospects, and to continue to reorganize or merge those institutions that will not be able to operate profitably, even in normal markets.

By providing additional flexibility to the regulators, the bills provide the agencies with the powers necessary to deal with the transitional problems faced by depository institutions.

FRAMEWORK FOR ASSISTANCE PROGRAMS

The bills before the committee do not fundamentally alter the basic authority or role of these agencies, but rather provide the framework for assistance programs for those depository institutions that, with some support, would likely survive a period of financial stress, and broaden merger possibilities for those institutions that probably cannot survive.

The bills, in our view, remove certain existing impediments, under carefully prescribed circumstances, that experience shows limit the ability of the regulators to deal with the practical realities facing them.

Up to the present time, the regulators have been able to respond to the problems under their existing authority. However, our Board is concerned that future circumstances may make it extremely difficult, if not impossible, for the agencies to find satisfactory solutions in specific instances, under existing statutory limitations.

Prudence dictates the removal of these existing limitations that may result in more costly or inefficient solutions, or which have the potential to widen the market impact of financial distress of a few depository institutions.

S. 2532 is, of course, very similar to the regulator's bill which Chairman Volcker recommended and endorsed in testimony on the chairman's S. 1720, before this committee last fall.

The bill n[illegible] fore t[illegible] committee has two main elements:

First, it br[illegible] [illegible]thority of the the FSLIC and the FDIC to provide fi[illegible] [illegible]a[illegible]e to distressed institutions, if such assistance would be [illegible] c[illegible]y to the insurance funds than assisted mergers or liqui[illegible]n.

Currently, t[illegible] can only provide such assistance when it f[illegible] that b[illegible] particular institution to be assisted is essential to [illegible]c[illegible] [illegible]ity, [illegible]d the assistance is less costly than other alter[illegible] [illegible] statutory test may hinder the ability of the [illegible] to [illegible] [illegible]tutions, particularly in markets where a large [illegible] or [illegible]tory institutions compete. In these heavily served [illegible] [illegible]ity test might be difficult to meet, even though [illegible]ure or [illegible]ion of one or more institutions might adversely [illegible] confi[illegible] in the financial services industry in that [illegible]

[illegible] F[illegible] no longer be constrained by the [illegible] [illegible], in addition, provide assistance to [illegible] to be viable in the long run when [illegible] exist which threaten the stability of a

significant number of" insured institutions. Such assistance is conditioned on a finding that it will "lessen the risk to the" insurance fund and will be less costly than liquidation.

ACQUISITION OF FAILING THRIFTS

Second, S. 2532 provides clear and specific guidance as to the circumstances under which failing thrifts can be acquired by out-of-State institutions or, as a last resort, in those circumstances where merger with another thrift is not practicable, by commercial bank holding companies. In order to facilitate mergers, the bill also overcomes limitations in some States that prohibit mutual thrifts from converting to the stockholder-owned form.

Earlier this year, the the Federal Reserve authorized one acquisition of a financially distressed non-FSLIC-insured savings and loan by a bank holding company, as Chairman Volcker previously indicated might be necessary if the Board were faced with an emergency situation.

The Federal Reserve Board has also returned a proposed application by a bank holding company to acquire a thrift institutions, because the major activity which the applicant proposed to undertake through the thrift and its service corporation—equity real estate development—is not permitted to bank holding companies.

Other bank holding companies recently have expressed interest in acquiring thrifts, some of which are not in critical condition. Consequently, the Board of Governors continues to believe that it is most desirable for the Congress to provide guidance on bank holding company acquisitions of thrift institutions. S. 2532 would provide this guidance.

The legislation would also authorize, again, under carefully prescribed circumstances, the acquisition of a failing large bank by an out-of-State bank or a bank holding company. Here, I am using "bank" in the sense of "commercial bank."

For several years, the regulators have asked for such authority because of their concern that in the event of failure of a large bank, there may not be an in-State institution capable of acquiring the failing commercial bank or savings bank.

Some observers have been concerned that such authority, as well as bank holding company acquisitions of financial distressed thrifts, might be used as a back-door method of undermining the principles established by the McFadden Act and the Douglas amendment. However, the prescribed procedures and limitations of the bill assure that this provision will be used for the resolution of serious individual problems, and not to facilitate a wholesale restructuring of the financial system.

Our Board views the thrust of the Capital Assistance Act of 1982, S. 2531, as a logical and desirable extension of the capital assistance authority of the Deposit Insurance Flexibility Act, S. 2532.

Capital infusion to institutions that have a reasonable prospect of viability when interest rates decline provides an efficient and cost-effective tool as an alternative to immediate liquidation or merger of financially distressed institutions. Capital infusion provides time for such institutions to rebuild their capital position from future earnings.

However, capital assistance should not be used to maintain the existence of institutions that find themselves in difficulty because of mismanagement or speculation, since they would be unlikely to recover even under favorable circumstances in financial markets.

S. 2531 explicitly addresses the latter concern, by prohibiting capital infusion to cover losses arising from mismanagement or speculation.

More generally, assistance is not automatic for all low-capital institutions incurring losses. The bill provides desirable discretion to the agencies, to assure that assistance is provided only to those institutions that have reasonable prospects for viability at lower interest rates than normal markets.

For these depository institutions, the bill establishes an initial schedule for capital infusion related to net worth and actual losses: the lower the net worth, the higher the amount of capital infusion that may be provided. However, the size of capital assistance called for by the schedule is always less than actual losses, and hence continues to bring market discipline to bear.

The bill therefore is not intended to allow a widespread "bailout" of financially distressed banks or thrifts, and indeed, the terms and conditions under which capital assistance may be provided assure that such bailouts will not occur.

In our view, S. 2531 recognizes that no single schedule can adequately take into account all the practical issues that the insurance funds may encounter. It therefore permits the funds to depart from the initial schedule and provide less or additional assistance if the schedule demands it. However, in no instance may assistance exceed an institution's losses for the immediately preceding period.

While the approach established by the bill appears to be adequate to meet the forseeable temporary needs of depository institutions, the Board would support additional flexibility that would permit, in carefully circumscribed instances, larger amounts of capital infusion if it would ultimately result in less cost to the insurance funds. For example, there may be specific situations in which it is desirable to raise the capital ratio of an institution with very low capital to a specific level, such as 2 percent, and maintain it at that level for a period.

CAPITAL INFUSION PROGRAM

T[illegible] Board believes that it is important that a capital infusion [illegible]n provide the insurance funds with discretion and flexibility [illegible] assistance programs to meet the unique needs of individ[illegible]tutions.

[illegible]ly, S. 2531 pr[illegible] considerable discretion, but the commi[illegible] minor modifications to assure that a [illegible]hieved and maintained, where desir[illegible]

[illegible]n, the number of assisted [illegible] would likely be larger, in[illegible]ce funds, all of which may [illegible] expenditures. While capital [illegible] current outlays, the notes [illegible]nstitutions may involve interest

payments that would be reflected in the budget; however, by forestalling the need for merger or liquidation of institutions that can be viable long run, both current and future budget expenditures should be reduced.

Indeed, by regarding capital assistance as net worth for statutory and regulatory purposes, the bill may prevent the need to merge or liquidate institutions that would otherwise be required to be closed under State law.

Still, it should be noted that Congress at some later date may find it necessary to consider providing supplementary resources to the insurance funds to help cover their obligations incurred under S. 2531.

In conclusion, let me reiterate that the Federal Reserve believes that the expanded authority along the lines authorized by these two bills is urgently needed, given the temporary circumstances faced by depository institutions. No one knows how long these difficulties will continue, but without such legislation, the Board is concerned that situations could develop in which the regulators would be unable to address the problems of particular distressed institutions in a prompt and cost-effective manner.

The Federal Reserve believes that there should be no question about the ability and willingness of the Government to assure the continued smooth functioning of our financial system as required in the public interest. Consequently, our Board supports the objectives of these bills and urges prompt action by the Senate along these lines.

[The complete statement follows:]

Statement by

Preston Martin, Vice Chairman

Board of Governors of the Federal Reserve System

I am pleased to appear before you today to present the Federal Reserve Board's views on S. 2531 (the Capital Assistance Act of 1982) and S. 2532 (the Deposit Insurance Flexibility Act). The Board welcomes Senate consideration of the issues raised by these two interrelated bills, supports their objectives, and urges prompt Senate action to increase the ability of the agencies to address the current financial problems facing the nation's thrift institutions.

As this Committee well knows, the present difficulties of the thrift industry, which S. 2531 and S. 2532 address, reflect the combination of rising deposit costs and portfolios composed largely of long-term fixed-rate assets acquired in periods of lower interest rates. As a result, such institutions in the aggregate have suffered significant operating losses and their capital position is being sharply eroded. The problem reflects the general conditions of the economy and the money market, as well as the long-run effect of public policies that have fostered portfolio concentration by thrifts in fixed-rate, long-term residential mortgages, rather than endemic poor management. The Board's view is that disinflationary policies will continue to succeed, contributing to lower and more stable interest rates, and a reversal of the pressure on thrift earnings and capital. The run-off of older portfolio assets and the growing use of alternative mortgage instruments will also work to improve earnings. In the interim, however, special measures are required to bridge the gap until more normal operating conditions are restored.

During the transition period, the regulatory agencies need the tools to support those institutions with sound assets and satisfactory

prospects, and to continue to reorganize or merge those that will not be able to operate profitably even in normal circumstances. By providing additional flexibility to the regulators, the bills provide the agencies with the powers necessary to deal with the transitional problems faced by depository institutions--especially the nation's thrifts.

The bills before the Committee do not fundamentally alter the basic authority or role of the agencies, but rather provide the framework for assistance programs for those depository institutions that, with some support, would likely survive a period of financial stress, and broaden merger possibilities for those institutions that probably cannot. The bills remove certain existing impediments, under carefully prescribed circumstances, that experience shows limit the ability of the regulators to deal with the practical realities facing them. Up to the present time the regulators have been able to respond to the problems under existing authority. However, the Board is concerned that future circumstances may make it extremely difficult--if not impossible--for the agencies to find satisfactory solutions in specific instances under existing statutory limitations. Prudence dictates the removal of those existing limitations that may result in more costly or inefficient solutions or which have the potential to widen the market impact of financial distress of a few depository institutions.

S. 2532 is very similar to the regulator's bill which Chairman Volcker recommended and endorsed in testimony on S. 1720 before this Committee last fall. The bill now before the Committee has two main elements. First, it broadens the authority of the FDIC and FSLIC to provide financial assistance to distressed institutions if such assistance will be less costly to the insurance funds than assisted mergers or

liquidation. Currently, the FDIC can only provide such assistance when it finds that both the particular institution to be assisted is "essential" to the community and that the assistance is less costly than other alternatives. The present statutory test may hinder the ability of the FDIC to assist institutions, particularly in markets where a large number of depository institutions operate. In these heavily served areas, the "essentiality" test might be difficult to meet even though the failure or liquidation of one or more institutions might adversely affect confidence in the financial services industry generally. Under S. 2532, the FDIC would no longer be constrained by the essentiality test. Rather, it could in addition provide assistance to institutions that are likely to be viable in the long-run when "severe financial conditions exist which threaten the stability of a significant number of" insured institutions. Such assistance is conditioned on a finding that it will "lessen the risk to the" insurance fund and will be less costly than liquidation.

Second, S. 2532 provides clear and specific guidance as to the circumstances under which failing thrifts can be acquired by out-of-state institutions or, as a last resort, in those circumstances where merger with another thrift is not practicable, by bank holding companies. In order to facilitate mergers, the bill also overcomes limitations in some states that prohibit mutual thrifts from converting to stock form.

Earlier this year the Federal Reserve authorized the acquisition of a financially distressed non-FSLIC insured savings and loan by a bank holding company, as Chairman Volcker previously indicated might be necessary if the Board were faced with an emergency situation. The Board has also returned a proposed application by a bank holding company to acquire a thrift

because the major activity which the applicant proposed to undertake through the thrift—equity real estate development—is not permitted to bank holding companies. Other bank holding companies recently have expressed interest in acquiring thrifts, some of which are not in critical condition. Consequently, the Federal Reserve continues to believe that it is desirable for the Congress to provide guidance on bank holding company acquisitions of thrift institutions. S. 2532 would provide this guidance.

The legislation would also authorize, under carefully prescribed circumstances, the acquisition of a failing large bank by an out-of-state bank or bank holding company. For several years, the regulators have asked for such authority because of their concern that in the event of failure of a large bank there may not be an in-state institution capable of acquiring the failing bank. Some observers have been concerned that such authority—as well as bank holding company acquisitions of financially distressed thrifts—might be used as a back door method of undermining the principles established by the McFadden Act and Douglas Amendment. However, the prescribed procedures and limitations of the bill assure that this provision will be used solely for the resolution of serious individual problems and not to facilitate a wholesale restructuring of the financial system.

The Board views the thrust of the Capital Assistance Act of 1982 (S. 2531) as a logical and desirable extension of the capital assistance authority of the Deposit Insurance Flexibility Act (S. 2532). Capital infusion to institutions that have a reasonable prospect of viability when interest rates decline provides an efficient and cost effective tool as an alternative to immediate liquidation or merger of financially distressed institutions. Capital infusion provides time for such institutions to re-

build their capital position from future earnings. However, capital assistance should not be used to maintain the existence of institutions that find themselves in difficulty because of mismanagement or speculation, since they would be unlikely to recover even under favorable circumstances in financial markets. S. 2531 explicitly addresses the latter concern by prohibiting capital infusion to cover losses arising from mismanagement or speculation.

More generally, assistance is not automatic for all low capital institutions incurring losses. The bill provides desirable discretion to the agencies to assure that assistance is provided only to those institutions that have reasonable prospects for viability at lower interest rates. For these depository institutions, the bill establishes an initial schedule for capital infusion related to net worth and actual losses—the lower the net worth the higher the amount of capital infusion that may be provided. However, the size of capital assistance called for by the schedule is always less than actual losses, and hence continues to bring market discipline to bear. The bill therefore is not intended to allow a widespread "bailout" of financially distressed banks or thrifts, and indeed the terms and conditions under which capital assistance may be provided assure that such bailouts will not occur.

S. 2531 recognizes that no single schedule can adequately take into account all of the practical issues that the insurance funds may encounter. It therefore permits the funds to depart from the initial schedule and provide less or additional assistance if the situation demands it. However, in no instance may assistance exceed an institution's losses for

the "immediately preceding period." While the approach established by the bill appears to be adequate to meet the forseeable temporary needs of depository institutions, the Board would support additional flexibility that would permit, in carefully circumscribed instances, larger amounts of capital infusion if it would ultimately result in less cost to the insurance funds. For example, there may be specific situations in which it is desirable to raise the capital ratio of an institution with very low capital to a specific level, such as 2 percent, and maintain it at that level for a period. The Board believes that it is important that a capital infusion program provide the insurance funds with discretion and flexibility to fashion assistance programs to meet the unique needs of individual institutions. Generally, S. 2531 provides considerable discretion, but the Committee may wish to consider minor modifications to assure that a specific capital ratio can be achieved and maintained where desirable in individual cases.

Without a capital infusion program, the number of assisted mergers and perhaps even liquidations would likely be larger, involving commitments by the insurance funds, all of which may show up as current or future federal expenditures. While capital infusion under this bill requires no current outlays, the notes issued by the insurance funds to the assisted institutions may involve interest payments that will be reflected in the budget. However, by forestalling the need for mergers or liquidations of institutions that can be viable in the long-run, both current and future budget expenditures should be reduced. Indeed, by regarding capital assistance as net worth for statutory and regulatory purposes, the bill may prevent the need to merge or liquidate institutions that would otherwise be required to be

The CHAIRMAN. Thank you very much, Governor Martin.

I would hope that each of our witnesses could hopefully summarize your remarks within 10 minutes, because we will place your full statement in the record.

Chairman Pratt?

STATEMENT OF RICHARD T. PRATT, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. PRATT. Thank you, Mr. Chairman. I'll try and stay within the 10 minutes.

First, we very much applaud your actions in bringing forth the legislation which is presented for hearings today. We think that this is an absolutely critical time in the lives of the financial institutions of this country and, most especially, of course, those which are thrift institutions. We believe there is a great opportunity for Congress to face the responsibility which exists at this time and to take the lead from the markets—which, in fact, are creating the deregulation, the changes and the restructuring of this industry—and provide some legislative oversight and some structure.

In looking at the legislation which has been proposed, we, of course, support both S. 2531 and S. 2532 and feel they will fill an important role at this time. In comparing S. 2531, which is a partial assistance program with a bill such as H.R. 6267, which might be a total capital maintenance program, we believe there are some strong factors that support S. 2531 and which make it the appropriate bill for ultimate passage into law.

SUPPORTING FACTORS

These would include, one, that it would be substantially easier to administer, using market forces as a substitute for the bureaucratic determinations contemplated under the alternative proposals.

Two, it would maintain incentives for institutions to cut costs and avoid operating losses, which would not be the case if all losses were covered and if institutions were maintained at a specified level.

Three, it would avoid the phenomenon of large numbers of thrift institutions moving rapidly toward zero net worth upon completion of the program, where they would have been supported at a minimum net worth level under the alternative, as opposed to what you have suggested.

Four, it would provide assistance that would have a positive impact on net worth under generally accepted accounting principles, which may not be the case under a net worth guarantee approach.

Five, it would avoid the volume of litigation likely to be generated by H.R. 6267, without eliminating the possibility of judicial review.

Six, it would be less expensive than the alternative approach, which would be total coverage and capital maintenance.

And seven, it would not follow the H.R. 6267 approach of mandating a reduction in investment flexibility as a condition of receiving assistance.

Finally, it would provide a narrower aid or a narrower class of institutions to assist than would H.R. 6267, avoiding, in particular, the policy of providing Federal aid to depositories that deliberately have chosen not to assume the expenses and restrictions connected with FSLIC or FDIC insurance coverage.

We think this is an important piece of legislation, one which will buy significant time. It should be recognized, however, that this legislation and other capital infusion programs that have been suggested simply buy time, and we believe that the Congress must face the issue of what are real solutions and what are band-aid approaches. In looking back at what have been promised as total solutions for this industry, I see such things as the All-Savers Act, the DIDC, and the joint resolution on full faith and credit, many of which we supported and participated in. But, in fact, they are band-aids, and they do not address the fundamental problems that are occurring in our financial system.

By itself, capital maintenance is nothing more than an initial band-aid and, standing alone, will merely be a program for euthanasia. In my opinion, it will ultimately lead to a weakened set of financial institutions unless it is combined at this time with some fundamental structuring and additional flexibility for thrift institutions and other depository institutions.

The world, the nonregulated financial world, is passing by the regulated financial institutions and is passing Congress by, and unless some steps are taken in the immediate time period to rectify that, we are going to see a substantial deterioration in the role and ability to serve our regulated depository financial institutions. By 1984, we are going to have a thousand or more institutions which, under the traditional definitions, are failing institutions. These institutions will be failing institutions with or without the capital maintenance which has been suggested. Again, their problems are those of legislative misstructuring, and this must be addressed.

We are facing, over time, the possibility of the collapse of a major portion of the financial industry and, in my opinion, we cannot go back to the earlier 1970's, to the 1960's, or to the 1950's. And any program which simply buys time and that does not address the fundamental issues is ultimately found to fail. Circumstances have fundamentally changed. As we come out of this interest rate cycle, we're going to have thrift institutions which are substantially weakened by the period of time that they have been through. They're going to have lower capital ratios. They are not going to have the protection of regulation Q—and this is a fundamental reform which I think is a positive one. Savers have more opportunities than they ever have had before. The markets are providing efficient vehicles for the people of America to invest their savings. I don't think they will stand for any reimposition of rate controls.

We have changed technology. Telecommunciations and the computer have made it possible for institutions to handle a large number of inve[illegible]rs, to make instantaneous transactions, and to handle [illegible] international facilities with ease. We have new c[illegible] money market mutual funds have grown to [illegible] y are not going to disappear when interest [illegible] going to have to be dealt with.

Thrift institutions, developed under a period of substantial protection and regulation, are high-cost operations, having operating costs of approximately 150 basis points. To justify the high cost structure and the substantial infrastructure which has been generated in this system, they are going to have to have access to additional services to offer the public to justify these facilities which are in place and which can be useful.

RESTRUCTURING

Restructuring is the immediate and long-term answer to the thrift institutions' problems. And it goes along directly with the legislation that you have presented at this time, representing a logical three-legged stool approach; that is S. 2531, S. 2532, and important aspects of S. 1720. In this regard, we would propose that a compromise be fashioned with regard to additional powers for thrifts, specifically, that commercial lending authority to the amount of 10 percent be granted at this time, with 20 percent in 1984 and 30 percent in 1986, that demand deposits for thrift institutions keyed to loan relationships be granted, that nonresidential real estate lending be allowed to perhaps 40 percent, and that consumer lending be permitted on an unlimited basis.

These reforms, when combined with S. 2531 and S. 2532, can put our thrift institutions back on a path to success, back on a path of serving the public, back into a position in which they can provide mortgage credit. At the present time, they are not providing significant mortgage credit, and without changes they will not be able to provide the mortgage credit which this country will need in the future. I reiterate, a legislative crippling of these institutions by limiting their investment powers is not going to provide the mortgate credit which will be needed in the future. The regulatory agencies have been accused of restructuring these industries through forced mergers. The regulatory agencies have seen a set of institutions which are failing, because of interest rates and because the market is changing around them. This administration is attempting to bring interest rates down. It looks like it may have a shot at doing so.

The other aspect that must be dealt with is the legislative modernization of this industry. We support S. 2531 and S. 2532 and feel it's imperative that aspects of S. 1720 be brought into this legislative package.

We appreciate the opportunity to appear before you, Mr. Chairman.

[The complete statement follows:]

STATEMENT OF

RICHARD T. PRATT, CHAIRMAN

OF THE

FEDERAL HOME LOAN BANK BOARD

Mr. Chairman, Members of the Committee, I appreciate the opportunity to appear before you today to testify on behalf of the Federal Home Loan Bank Board concerning S. 2531, the Capital Assistance Act of 1982, and S. 2532, a revision of the so-called "Regulators' Bill." The bills are designed to assist the thrift industry by providing, respectively, net worth assistance to savings institutions and additional flexibility to their federal regulatory agencies. The Bank Board believes, Mr. Chairman, that you have performed a very valuable service by introducing these bills and holding hearings on them. The problems of the thrift industry are extraordinarily severe, and it is proper that Congress is considering extraordinary responses. The Bank Board has helped develop both bills, and, should Congress determine that the thrift situation merits special action, believes that S. 2531 and S. 2532 offer appropriate approaches to the industry's problems.

Before providing specific comments on S. 2531 and S. 2532, however, I would like to present some economic data on the current and projected state of the savings and loan industry. This information should help you evaluate the need for these measures. In addition, I will describe some of the actions of the Federal Savings and Loan Insurance Corporation and explain why we believe thrift restructuring should be a high priority for Congress.

1. State of the Savings and Loan Industry

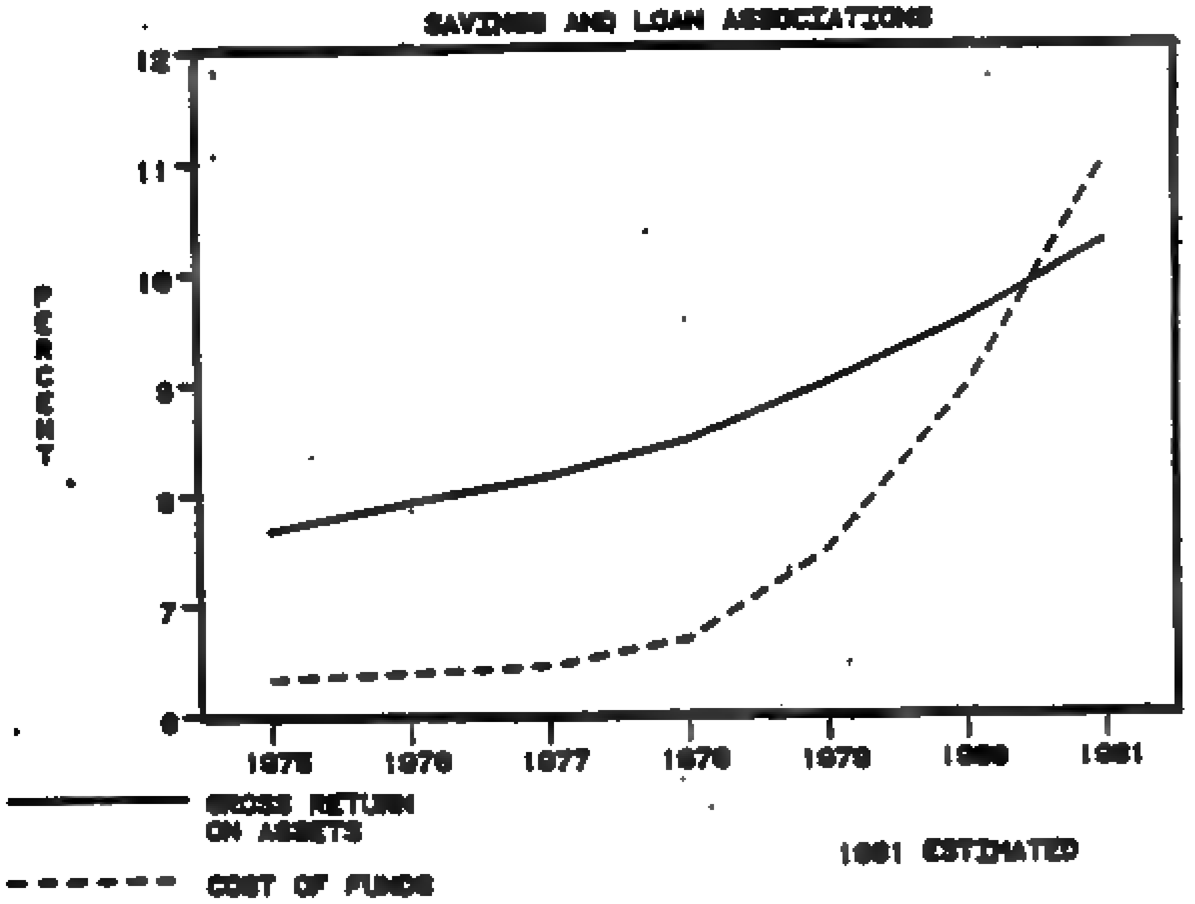
As we have testified previously, the thrift industry is undergoing a severe financial crisis. Thrift financial distress is at a level not encountered since the Great Depression. Our past tolerance of inflation has generated high and volatile interest

rates that are literally threatening the survival of this industry, which various statutory and regulatory constraints over the years have left poorly equipped to withstand the severe stresses it is experiencing.

2. Experience in 1981

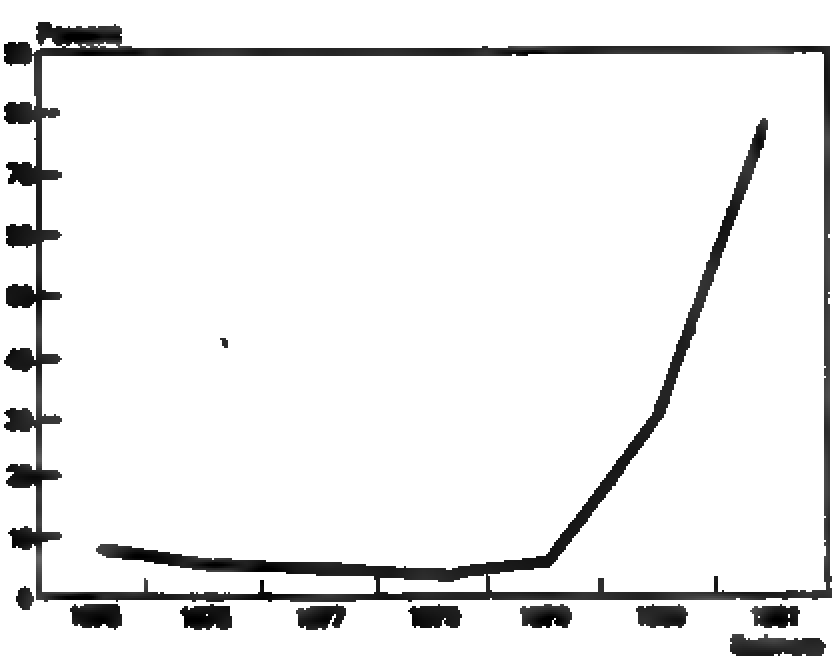
For savings and loan associations, the dominant feature of the economic landscape in 1981 was the record level of interest rates. Yields on 6-month Treasury bills, for example, averaged 13.8 percent, almost 250 basis points above the average 1980 rate. The consequence of this phenomenon for thrifts was a large and expanding negative spread between their cost of funds and their gross return on assets.

GROSS RETURN ON ASSETS AND COST OF FUNDS
SAVINGS AND LOAN ASSOCIATIONS



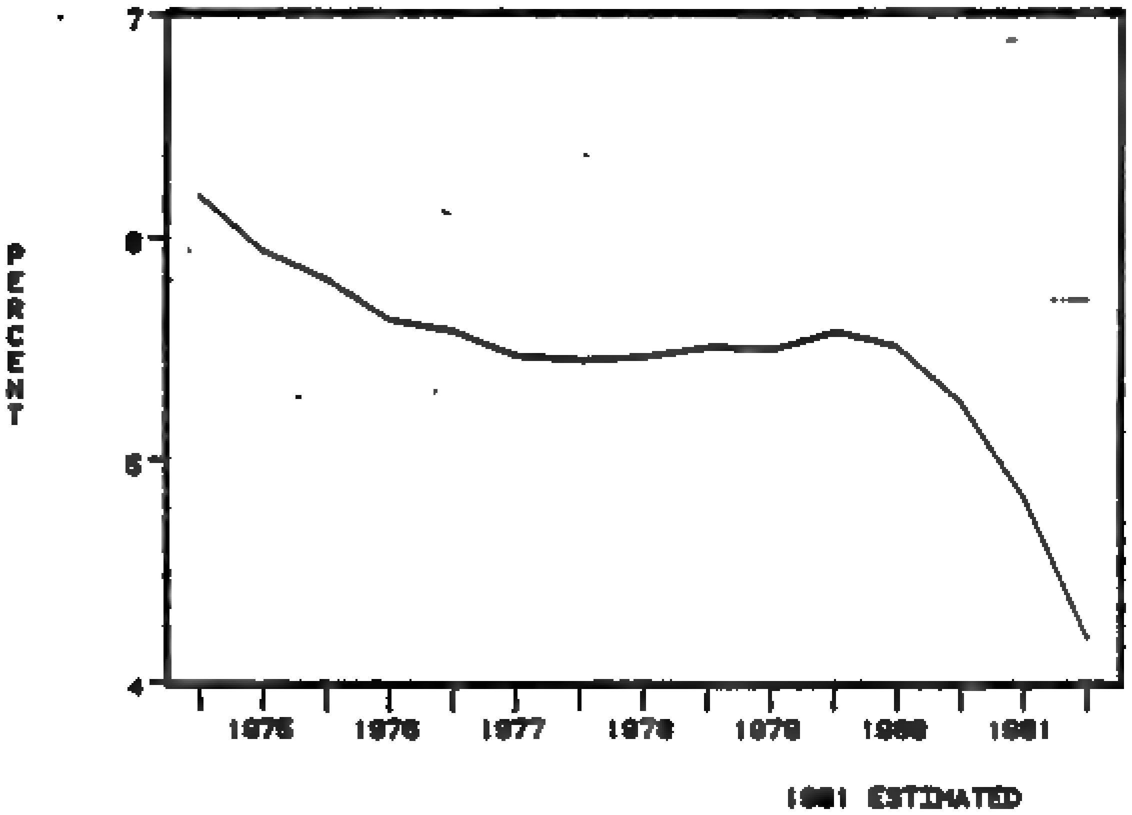
For 1981, S&Ls experienced an <u>average</u> cost of funds (both deposits and borrowings) of 10.92 percent. Moreover, the cost of funds tended to increase rapidly over the course of the year, with the second half figure standing at 11.53 percent. By contrast, slow replacement of old mortgages led to an extremely sluggish increase in S&L gross asset yields, which averaged 10.28 percent for the year, and only 10.46 for the second half. On an average basis, 1981 saw a gap of negative 64 basis points between S&Ls' cost of funds and their gross return on assets, and for the second half of 1981 the gap widened to negative 107 basis points. This translated into a negative .75 percent return on assets for the S&L industry in 1981, with approximately 80 percent of all institutions insured by the FSLIC experiencing losses.

Percent of Savings and Loan Associations Experiencing Losses



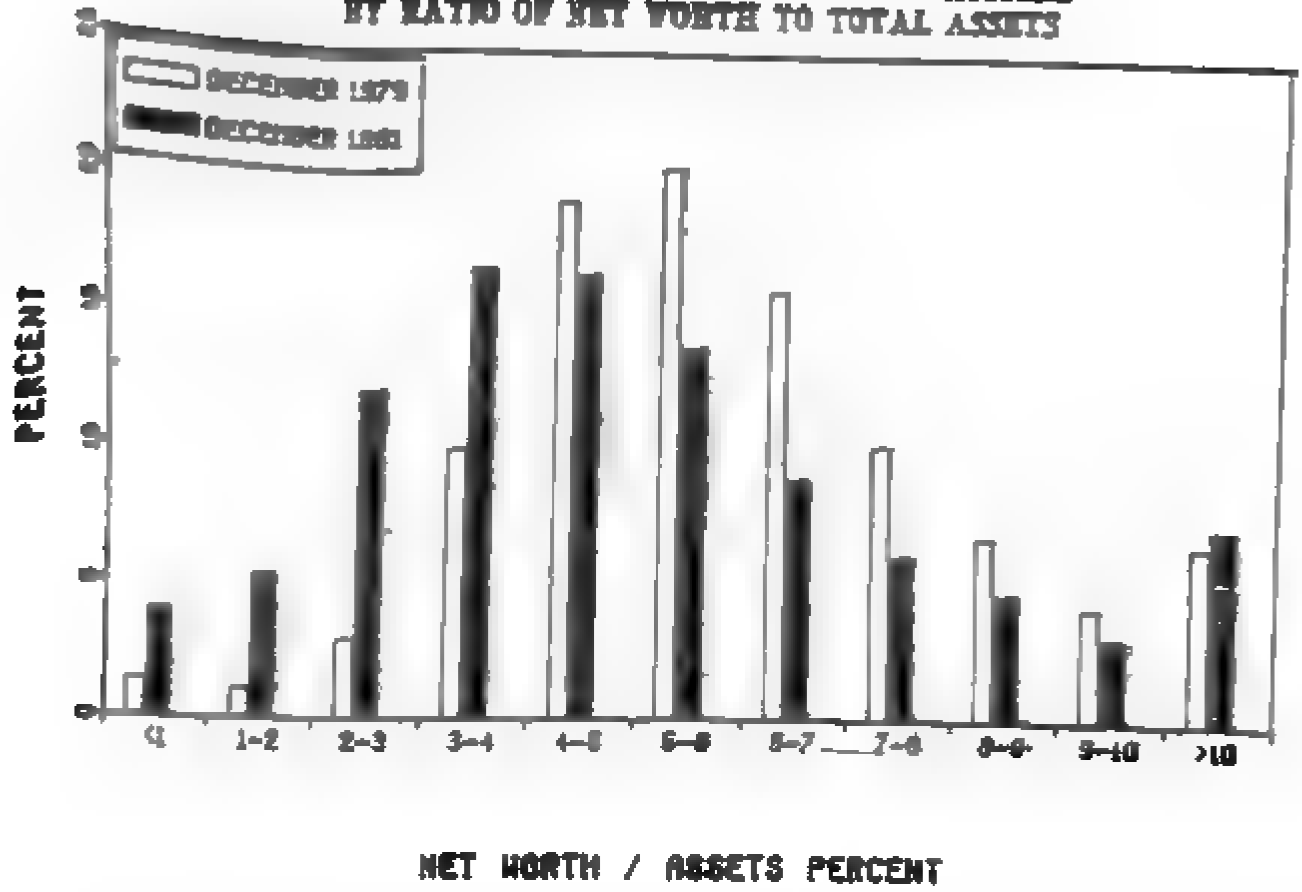
In dollar terms, the industry suffered a record net after-tax loss of $4.6 billion -- with a record semiannual loss of $3.1 billion occurring in the second half -- and saw its collective net worth eroded by about 15 percent. At year end, industry net worth stood at $27.6 billion, or 4.2 percent of total association assets.

NET WORTH AS A PERCENT OF TOTAL ASSETS
SAVINGS AND LOAN ASSOCIATIONS

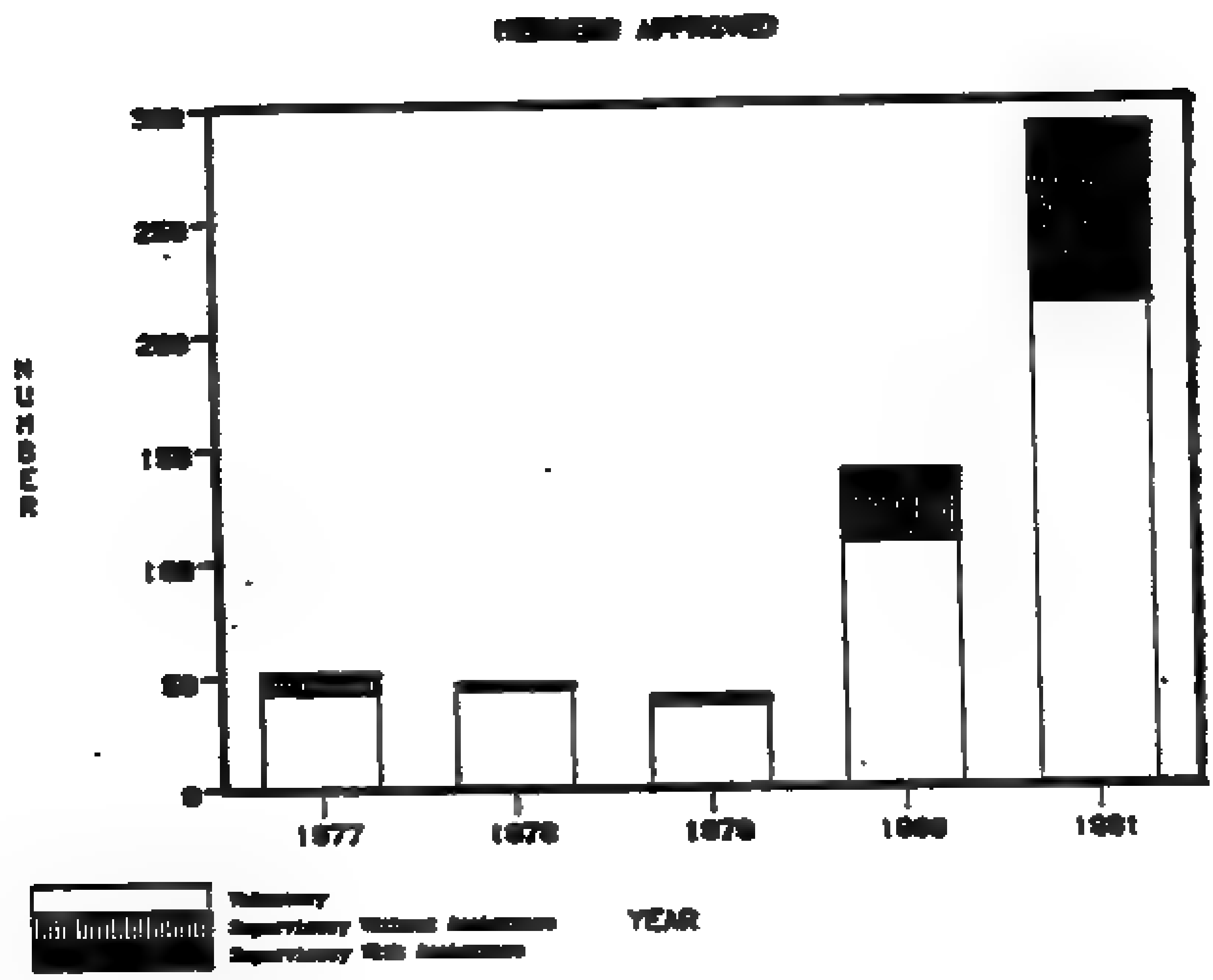


This figure conceals, of course, considerable variation in individual conditions. Almost 10 percent of FSLIC-insured institutions, for instance, had net worth less than 2 percent of assets as of the end of 1981. In all, 356 associations with $72 billion in assets fell into this category.

PERCENTAGE DISTRIBUTION OF ASSOCIATIONS
BY RATIO OF NET WORTH TO TOTAL ASSETS

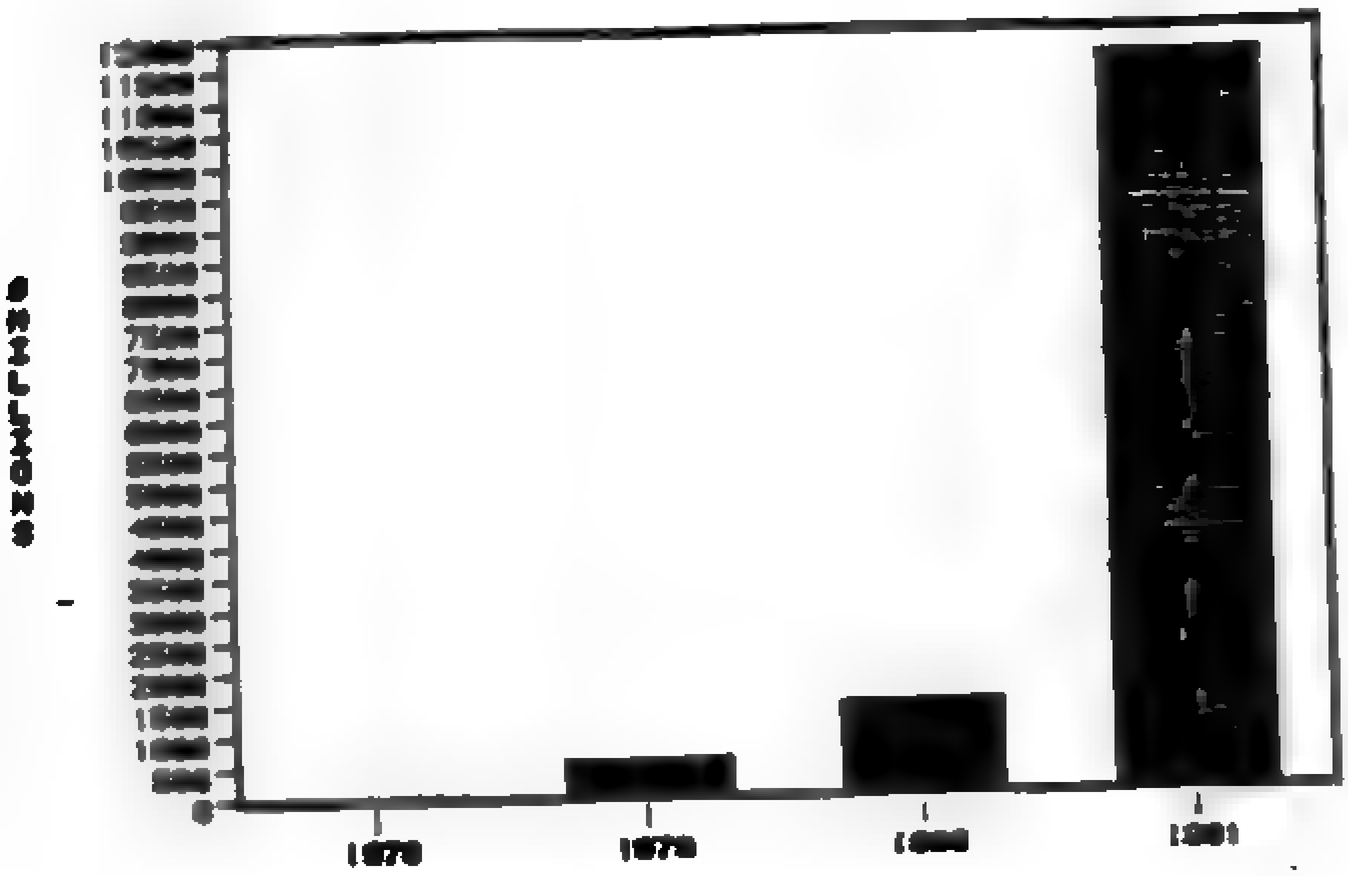


The problems of the industry caused a great increase in consolidation as associations sought to enhance their competitive prospects. A total of 296 mergers occurred in 1981, more than doubling the 1980 figure of 141. Supervisory mergers made up about 25 percent of the total, and, of these, 23 involved FSLIC financial assistance. This level of supervisory activity was about 10 times greater than in an earlier typical year.



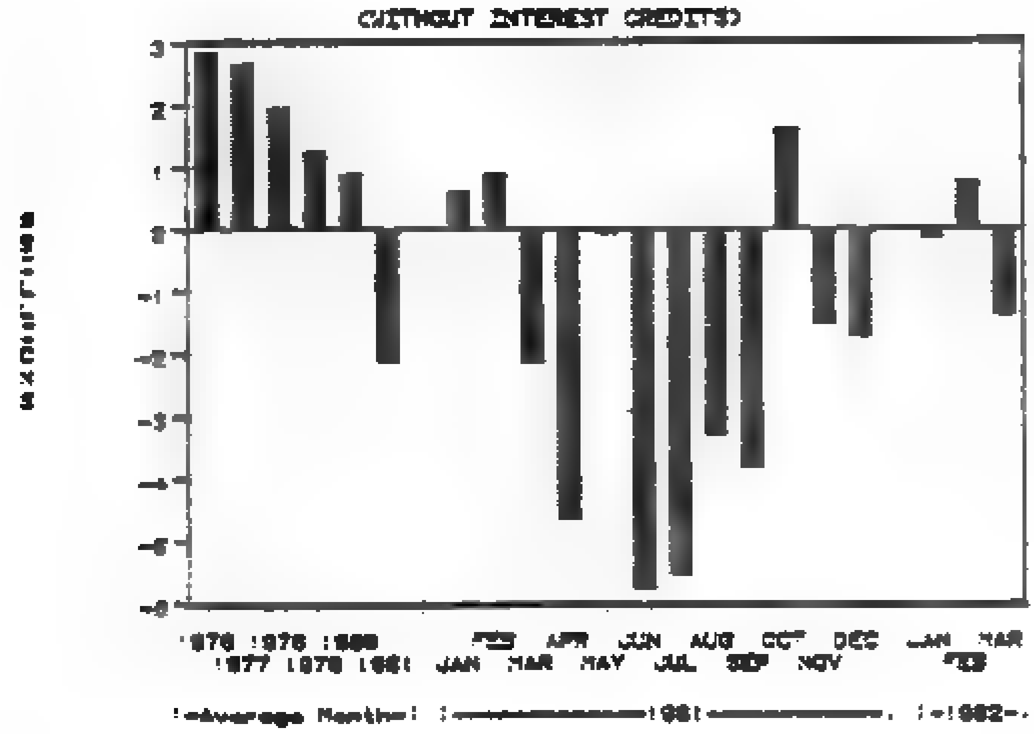
Mergers financially assisted by the FSLIC in 1981 involved disappearing institutions with total assets of $11.7 billion, as opposed to $1.4 billion in 1980.

TOTAL ASSETS OF FSLIC ASSISTED CASES



The problem of the industry's losses, unfortunately, has been jointed by the related, and very threatening development of severely impacted savings flows. Net deposit outflows in 1981 totalled $25.5 billion.

NET NEW DEPOSIT RECEIPTS OF SAVINGS AND LOAN ASSOCIATIONS
(WITHOUT INTEREST CREDITS)



This phenomenon has two causes. First, S&Ls have encountered aggressive and successful competition from money market mutual funds. These entities, which are regulated to a much lesser degree than their depository institution competitors, grew by almost $110 billion in 1981, almost entirely at the expense of S&Ls and other financial institutions.

Second, the Bank Board is convinced that savings movement from S&Ls has amounted to "cross-intermediation" resulting from depositor nervousness regarding the condition of the thrift industry. This is evidenced by the fact that, for account categories where bank/thrift interest rates are the same, customers are shifting very large quantities of funds from S&Ls to commercial banks on a net basis. For example, money market certificate balances at S&Ls in 1981 actually declined by 1 percent, while commercial bank MMC deposits increased by 21.8 percent. The widespread negative publicity afforded the industry clearly has eroded to a degree the faith of many savers in the implicit assumption that Congress always would provide the FSLIC with enough funds to protect depositors. While it is still too early to determine the effect of the recent actions Congress took to address this situation, we believe that, by passing the resolutions on full faith and credit, you have provided an important boost to depositor confidence that should help us a very great deal in fulfilling our responsibilities.

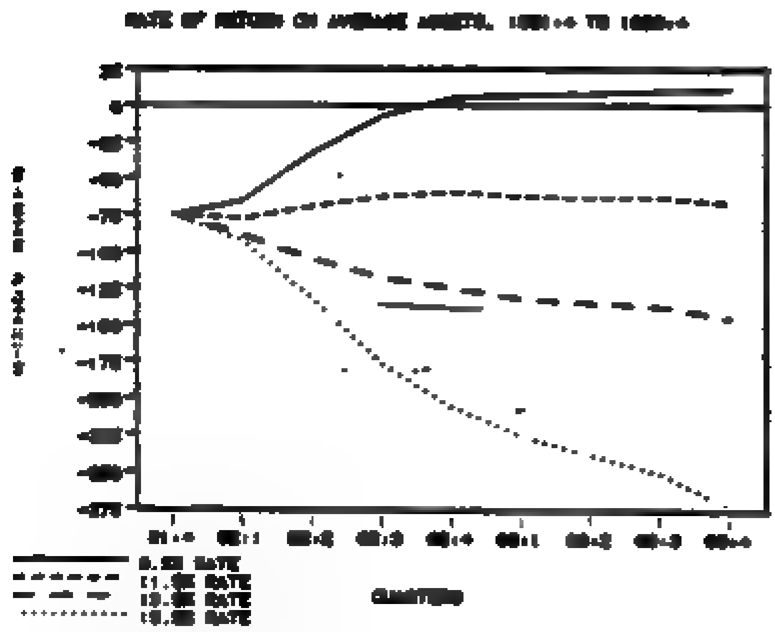
Unavoidably, the enormous funds outflows that have occurred have drastically diminished the ability of the thrift industry to serve as a source of housing finance. FSLIC-insured institutions closed only $52.1 billion in mortgage loans in 1981. This amount was 27 percent lower than the 1980 figure, and represented the smallest lending volume since 1974, a year in which, one should note, the industry financed far more individual transactions than in 1981 because of the lower prices of homes. A continued decline in the percentage of net new mortgage debt acquired by S&Ls also characterized 1981, with the S&L share dropping to 26 percent for

the first three quarters of 1981. This compares with a 30 percent share in 1980, and a 50 percent share during most of the 1970s. Perhaps most telling, in the second half of 1981, S&Ls were responsible for only 4 percent of the total growth in home mortgage debt.

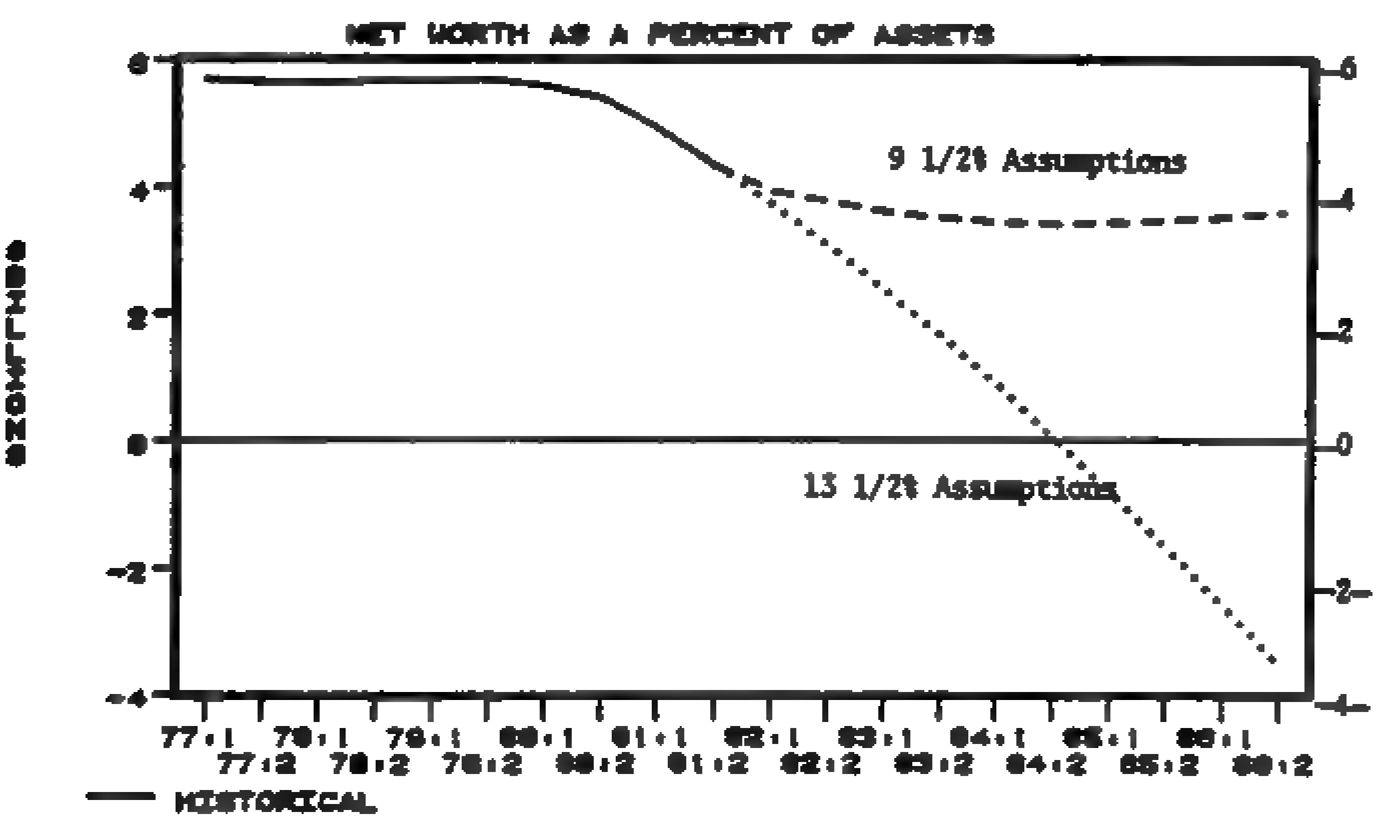
3. Outlook for 1982 and the Future

The current year offers little cause for encouragement. Prospects, of course, hinge almost entirely on the behavior of interest rates. If interest rates on short-term Treasury issues in 1982 average approximately in the 13.5 percent range -- without factoring in industry restructuring, federal capital assistance, or possible DIDC actions -- we project that some 944 associations, with assets of $220 billion, will reach net worth levels of 2 percent or less, and that 222 of these, having assets of $57 billion, will run out of capital. Continuation of such rates through 1983 would result, we estimate, in 1,622 associations, representing $425 billion in assets, falling below 2 percent net worth; 558 associations, having assets of $130 billion, would reach zero net worth.

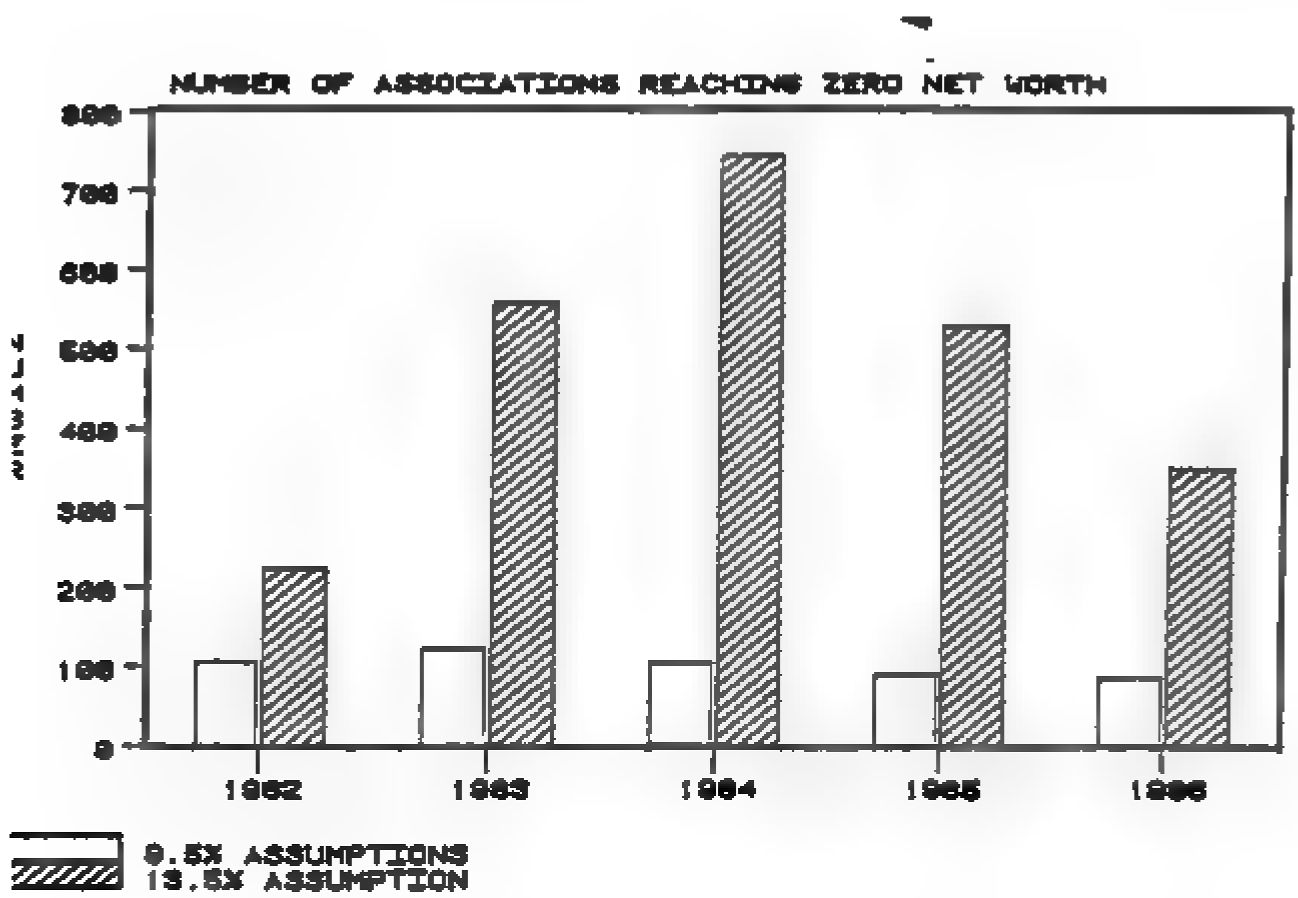
To generate an early recovery of the industry would require a 6-month T-bill rate through 1983 and beyond of 9.5 percent. Even an 11.5 percent rate would leave the industry suffering negative earnings.

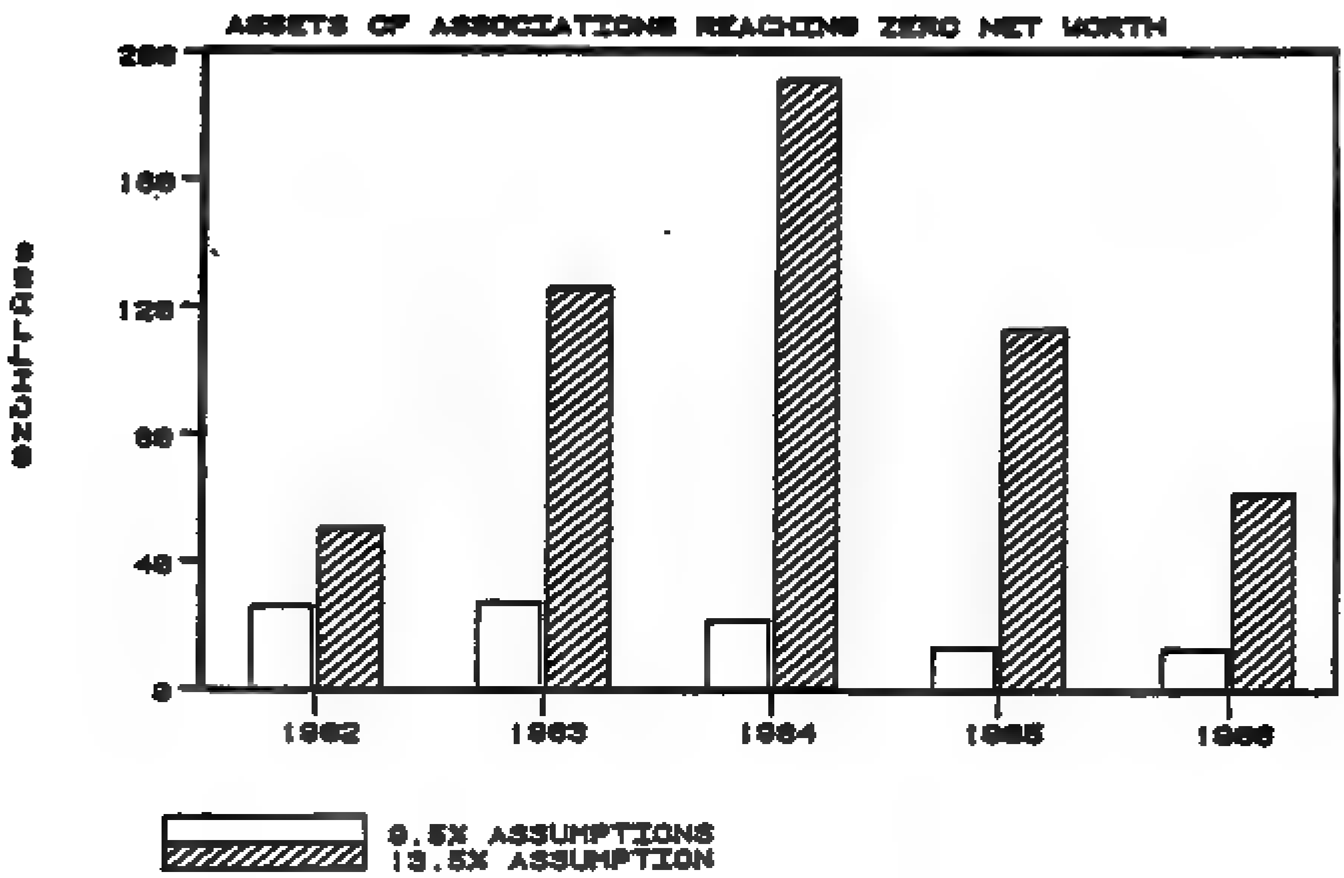


Moreover, persistence of rates in the 13 1/2 percent range would bring the industry's average net worth to zero by the middle of 1984.



Were we to attain and maintain a 9.5 percent rate, however, the industry still would be in a very weak net worth position. At year end 1982, we could expect 390 S&Ls, with $85 billion in assets, to be at or below the 2 percent net worth level. We project this category would increase to 600 associations, representing $125 billion in assets, by the end of 1983. Institutions exhausting their capital over the 2-year period would number about 227, with total assets of $52.7 billion.



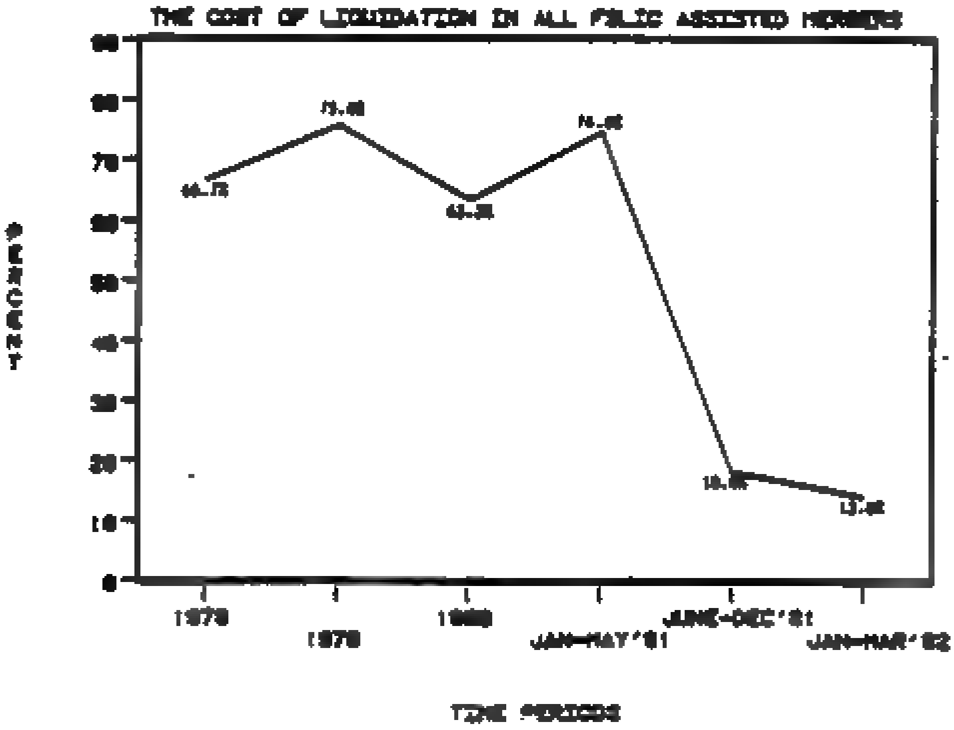


4. FSLIC Activities

The severe economic difficulties of the thrift industry have placed enormous demands upon the Bank Board, which I feel the agency has handled well, thanks to the creativity, hard work and long hours of its staff. In particular, we are pleased with the new approaches the FSLIC has developed for dealing with problem cases, including recourse to a wider range of merger partners and use of a greater variety of default prevention actions. These new

approaches have produced a considerable stretching of the financial and human resources available to the FSLIC. In the first 5 months of 1981, for example, the FSLIC resolved problems with assets of $1.5 billion at an estimated present value cost of $344 million, or 22 percent of assets--a typical cost-asset ratio for default prevention cases over the last several years. During the remainder of 1981, by contrast, the FSLIC resolved 23 cases, having assets of $12.3 billion, at an estimated present value cost of $633 million or 5.1 percent of assets--one fourth of the historical cost-asset ratio for resolving problem cases. Likewise, 1981 saw a decrease in the total present value cost of FSLIC assistance as a percentage of the cost of liquidation.

TOTAL PRESENT VALUE COST OF FSLIC ASSISTANCE AS A PERCENTAGE OF THE COST OF LIQUIDATION IN ALL FSLIC ASSISTED MERGERS



Cash outlays in the last 7 months of 1981 were less than 0.5 percent of assets. The figure for the first five months of 1981 was 61 percent of assets.

Despite these measures, the FSLIC's uncommitted reserves at the beginning of 1981 were somewhat less than they were at the end of 1980. A significant contributor to this reduction was our decision to establish contingency reserves to cover losses that we anticipate will be incurred over the life of assisted mergers in force through the end of 1981.

While we are pleased with what the agency has accomplished, all we really have done, in truth, considering the staggering dimensions of the problem, is buy some time. By using mergers as a supervisory tool when a problem cannot be resolved by cost-cutting or securing outside capital, we are seeking to spread as much of the industry's own net worth as possible over the industry's trouble spots as a means of conserving the FSLIC's insurance fund. Many have suggested that there is a limit to the usefulness of the merger approach. That limit is not near, but situations have arisen where a suitable merger could not be arranged at a reasonable cost--thus requiring the FSLIC to provide net worth support until a more cost-effective resolution of the problem, such as a merger, can be achieved.

5. Need for Restructuring

What greatly concerns the Bank Board is that the time the FSLIC has been buying--and that Congress is considering purchasing through S. 2531 and S. 2532--is put to appropriate use. As I have

testified previously, we believe that it is critical that Congress promptly initiate the asset-side and other restructuring that the S&L industry needs so urgently. Defective structuring, in our view, is a primary cause of the present economic vulnerability of the thrift industry, and effective restructuring, along the lines of what is contained in S. 1703, the Thrift Institutions Restructuring Act of 1981, which you have incorporated into S. 1720, the Financial Institutions Restructuring and Services Act of 1981, is the only lasting cure.

The current approach to deregulation represented by deregulating thrifts' liability side without providing them with any additional asset flexibility is assymetric and inherently unworkable. If thrifts are to be required to pay market rates in order to compete for deposits, as is mandated by Public Law 96-221, then they must be given investment flexibility sufficient to generate the earnings needed to pay those rates. The ability of small commercial banks to remain profitable in this volatile interest rate environment--in stark contrast to thrifts, which they often strongly resemble--is entirely the result of the variety of investment possibilities available to the banking industry, and the access of banks to interest-free demand deposits. Utilization by thrifts of a reasonable amount of commercial lending authority could buffer them significantly against adverse economic developments.

Objections to restructuring generally relate to a possible adverse impact on housing, or are based on the premise that restructuring is a long-run problem that can wait for a solution.

Concerning housing, the Bank Board believes that providing commercial lending authority to S&Ls will not signal any significant desertion of home finance. Housing is the business S&Ls know best. It is extremely doubtful that they would engage in a mass abandonment of their area of greatest expertise for the untested delights of commercial lending. In the Bank Board's opinion, they basically would use commercial lending as a device to preserve their capacity to continue as providers of housing finance. The existence of truly rate-sensitive mortgage instruments and the continued existence of the favorable bad debt deduction contained in section 593 of the Internal Revenue Code would reinforce the tendency to stay in housing.

With respect to the notion that restructuring is a postponable "long-term" problem, the Bank Board is convinced that the current crisis cannot be dealt with in any meaningful way without restructuring. The difficulties of the thrift industry largely result from the fact that thrifts have been constrained by law and regulation to operate in a manner inconsistent with the logic of the marketplace. Without being relieved of those constraints, thrifts will not be able to achieve a lasting recovery from their present problems. It would take some time for the thrift industry to learn to use new powers effectively, of course, but, in our opinion, this only argues more powerfully for their quick enactment. We note that new empowerments, by enhancing the value of thrift charters, would attract more investment dollars to thrifts, thus helping stem the erosion of net worth that is among the industry's greatest current problems.

6. <u>Comments on S. 2531 and H.R. 6267</u>

Before discussing S. 2531, the Capital Assistance Act of 1982, and a similarly intended measure, H.R. 6267, the Net Worth Guarantee Act, that recently was approved by the House of Representatives, I would like to comment generally concerning initiatives of this nature. First, from a philosophical standpoint, I am uncomfortable with having the government intervene to prevent corporate failures. Generally speaking, the efficient functioning of a free enterprise system implies the failure of unprofitable businesses. It seems clear, however, that there are circumstances when intervention is appropriate to achieve some overriding national objective. Maintaining critical defense industries is one example. Preserving a stable banking and financial system is another. Considering the extent of the thrift problem, and its overall implications for the economy, it would appear that authorizing an expanded federal financial presence may be a prudent step.

Should federal intervention occur, it should be structured in such a way that it is market-disciplined, efficient to administer, and Darwinian in impact, allowing the weakest members of the industry to go out of existence, while preserving the stronger institutions. We believe that S. 2531 satisfies these criteria, but that H.R. 6267 does not.

The fundamental difference between the two bills is the extent of coverage of losses. H.R. 6267 would attempt to support associations with reasonable prospects for long term viability at a 2 percent net worth level, with additional assistance thereafter contingent on a determination of whether continuing losses

were caused by market conditions, as opposed to the institution's own actions. By contrast, S. 2531 would provide net worth sufficient only to cover a percentage of an institution's losses. For example, the bill indicates that associations in the 3 percent to 2 percent net worth range would receive coverage equal to 30 percent of their actual losses, institutions in the 1 percent to 2 percent net worth range would receive coverage equal to 40 percent of their losses, and associations in the 0 percent to 1 percent group would receive 50 percent coverage.

In the opinion of the Bank Board, S. 2531 is the superior bill in that:

(1) It would be substantially easier to administer, using market forces as a substitute for the bureaucratic determinations contemplated under H.R. 6267;

(2) It would maintain incentives for institutions to cut costs and avoid operating losses, unlike H.R. 6267;

(3) It would avoid the phenomenon of large numbers of thrift institutions moving rapidly toward zero net worth upon completion of the program, for they would not have been supported at a minimum net worth level, in contrast to H.R. 6267;

(4) It would provide assistance that would have a positive impact on net worth under generally accepted accounting principles, which may not be the case under H.R. 6267;

(5) It would avoid the great volume of litigation likely to be generated by H.R. 6267;

(6) It would be less expensive than H.R. 6267;

(7) It would not follow the H.R. 6267 approach of mandating a reduction in investment flexibility as a condition of receiving assistance; and

(8) It would provide aid to a narrower class of institutions than would H.R. 6267.

A. Ease of Administration: A major advantage of S. 2531 is that it would be substantially easier to administer. Under H.R. 6267, as indicated, eligibility to receive assistance would turn initially on the Bank Board's decision regarding whether the potential recipient had reasonable prospects for long-run viability, with receipt of assistance after the first two years depending upon a finding that further losses were caused by general market conditions and not by the association's own actions. These assessments, particularly the determination relative to long-run viability, would be extremely difficult to make, and would place a very heavy and subjective responsibility on the Bank Board's staff. Under S. 2531, by contast, the basic threshold criterion for receiving capital assistance would be a determination that an institution would remain solvent for more than six months, an objective and relatively simple short-term projection. Questions on long-term viability would be answered by the dynamics of the marketplace, rather than by agency personnel.

B. Loss Reduction Incentives: A primary reason for the use in S. 2531 of partial loss coverage is to maintain pressure on institutions to take all possible measures to cut costs, and to remove any predilection to incur losses artificially because of the existence of a subsidy. Explicit, of course, in H.R. 6267

is an obligation on the part of the Bank Board to ensure regulatorily that efficient cost-cutting and loss-avoidance practices are observed by assisted institutions. Nevertheless, requiring efficient operation by fiat can be expected to be a far less effective approach than using market forces to create internal imperatives within management to perform in the most economical manner possible. The administrative process of monitoring association adherence to requirements relating to economical operation would be extremely onerous both for the agency and the assisted institutions. In effect, the Bank Board would be required to oversee from a cost standpoint virtually every aspect of an institution's operations. The Bank Board would be compelled to scrutinize expenditures for items such as automobiles, travel and entertainment, evaluate salary levels, and pass on such matters as advertising budgets. With respect to Congressional concern with deregulation, this inescapable concomitant of H.R. 6267 would be an enormously retrograde step.

C. Caseload Overhang: By providing for only partial coverage of losses, S. 2531 would facilitate an orderly handling of supervisory cases. The descent of institutions to zero net worth and failure would be slowed, allowing more comprehensive attention to be paid to individual cases. The H.R. 6267 approach, however, would have the effect of suspending very large numbers of institutions at the 2 percent net worth level until exhaustion of available guarantees, at which point, assuming interest rates do not dramatically improve, the FSLIC would be confronted with a resumed downward drift by a very large segment of the industry.

If interest rates average in the 13.5 percent range, we estimate that in 1984, under H.R. 6267, 1,030 institutions, representing assets of over $240 billion, would reach zero net worth. Such a simultaneous descent to insolvency from the relatively low 2 percent net worth level could place a substantial strain upon the Bank Board's resources. Use of the S. 2531 approach would result in 1984 in 636 insolvencies, involving assets of $133.5 billion -- a far more manageable volume.

D. Effect of Assistance on Net Worth: One of the reasons we strongly support S. 2531 rather than H.R. 6267 involves the issue of whether the assistance provided would be treated as net worth under generally accepted accounting principles (GAAP). Both bills would provide effectively for satisfaction of regulatorily accepted accounting principles (RAAP). While S. 2531 basically would use income capital certificates and follow procedures currently employed in the Bank Board's "Phoenix Program" that have been determined to satisfy GAAP by a significant number of "Big Eight" accounting firms, we have been concerned that H.R. 6267, which would utilize a novel and untested approach, would not. Based upon a May 19, 1982 letter to the minority staff of the House Banking Committee from Mr. J.T. Ball, Assistant Director for Research and Technical Activities of the Financial Accounting Standards Board, it now appears that our concerns are solidly grounded, and that there is a considerable possibility that H.R. 6267 would not provide savings institutions with any net worth increments recognizable under GAAP.

The specific problem arises from the fact that H.R. 6267 would seek to offset institutions' losses with Treasury Department

guarantees that could be converted into cash only upon the liquidation of the recipient. This differs considerably from the S. 2531 approach of providing institutions with fixed-term promissory notes in exchange for income capital certificates that would be amortized out of net income. Unlike the promissory note contemplated under the S. 2531, the guarantee, in the opinion of the FASB staff, "cannot be considered a probable future economic benefit that has been obtained by and is under control of the thrift because the thrift itself will never realize any cash flows that are directly or indirectly attributable to the guarantee," and, thus, "would not be recognized as an asset of an thrift institution under GAAP."

The practical significance of this defect in H.R. 6267 could be very great. Publicly-held thrifts must disclose their condition in accordance with GAAP, as must any other stock or mutual institution that wishes to make public offerings of debt securities. H.R. 6267 does not appear to intend to eliminate these requirements. Thus, the net worth guarantees provided by H.R. 6267 may not contribute to strengthening an institution's net worth in the eyes of investors, analysts and other interested parties, who would be expected to rely on objective GAAP standards rather than fiat RAAP approaches. It also may not improve public confidence in such associations, since media accounts of their condition might stress the poorer and thus more newsworthy results reported under GAAP. For significant segments of the industry, therefore, H.R. 6267 could fail to provide the improved public financial posture needed to build confidence on the part of depositors and other investors. This improved posture, of course, is

a very important element in assuring that, under either bill, federal net worth assistance comes at a minimal ultimate cost to the Treasury.

E. Exposure to Lawsuits: Because the question of whether an institution will receive assistance or not could mean its survival or failure, the Bank Board can expect to be sued by virtually every disappointed applicant. This litigation would be very expensive and time-consuming, and generally could place a great burden on our legal and other staff resources. S. 2531 would address this problem by explicitly committing to agency discretion the various determinations surrounding the framing and execution of any net worth assistance plan adopted under the bill. While this by no means would remove Bank Board actions under the bill from judicial scrutiny, it would ensure a narrower scope of review, and thus act as a deterrent to litigation. H.R. 6267 lacks explicit language regarding agency discretion, and consequently is an open invitation to lawsuits--particularly in light of its "reasonable prospects for long-term viability" standard, which, of course, is absent from S. 2531.

F. Cost: According to Bank Board estimates, 1,632 thrift institutions would have low enough net worth to participate over the life of the H.R. 6267 program. Assuming the 6-month Treasury bill rate continues in the 13.5 percent area, the federal government would incur contingent liabilities under the plan totalling $1.7 billion by the end of 1982, $6.63 billion by the end of 1983 and $8.5 billion by the end of 1984. By contrast, contingent liabilities under S. 2531 would total $700 million by the end of 1982, $2.42 billion by the end of 1983, and $4.66 billion by the

end of 1984. If the Bank Board structures the program to pay interest on the promissory notes provided institutions, actual cash outlays would total $1.4 million through the end of FY 1984, assuming a .4 percent interest rate on the note. It is projected that by year-end 1984 1,430 institutions would be receiving assistance; although a larger number would have participated over the period of the program, some of the earlier participants would have merged. S. 2531 thus is the less expensive of the two bills.

G. Investment Flexibility: One of the requirements under H.R. 6267 is that an institution receiving assistance must invest 60 percent of its net new deposits in housing loans. While this stipulation would have little practical effect, given thrift savings flow experience, the Bank Board regards the provision as inappropriate, and is pleased that no similar requirement appears in S. 2531. The condition of the thrift industry is simply too critical to reduce thrifts' investment flexibility. The ability of thrift institutions to maximize their returns is central to their ability to survive the current crisis. To seek to interfere with this ability, in our judgment, is simply bad policy. If Congress wishes to subsidize the housing industry, we urge that it do so on a direct basis rather than in the indirect fashion contemplated in H.R. 6267.

H. Nature of Institutions Covered: S. 2531 is considerably superior to H.R. 6267 with respect to the set of institutions that would be eligible for assistance. While S. 2531 would permit assistance to be given only to institutions with 3 percent net worth or less, in our understanding, effectively limiting assistance to FDIC-insured banks to mutual savings banks, H.R. 6267 would

allow assistance to be given to commercial banks having net worth of 100 basis points below their minimum capital level, thus permitting such banks to receive aid at net worth levels that would render them ineligible for assistance if they were thrifts. At a more fundamental level, we see no justification for providing a federal subsidy to certain unhealthy members of the commercial banking industry, which, as a whole is quite healthy -- especially since there is no indication that those institutions' ills stem to any degree from fulfilling particular federal policies.

Even more egregious, in our view, is the provision in H.R. 6267 for providing federal aid to institutions that are not FSLIC- or FDIC-insured. We fail to see any sound policy basis for such a step. The privately-insured institutions that would be helped have deliberately chosen to avoid the regulatory restrictions surrounding federal deposit insurance, and can point to no federal statutes as the source of their difficulties. Aid to such institutions is certainly not necessary to preserve the nation's financial structure -- their overall position in the economy is not significant enough for substantial failures among them to damage the banking system. Furthermore, we reject the notion that depositors would confuse these institutions with entities insured by the FDIC or the FSLIC. In effect, what H.R. 6267 would do is provide bargain-basement federal deposit insurance to institutions that in the great majority have consciously decided to avoid the expense and restrictions connected with coverage by the FDIC or FSLIC. We fear that the lesson taught by H.R. 6267 in this regard is that depositories need not put up with the cost and inconvenience of

federal deposit insurance because, in the event of serious troubles, they can depend on a federal bail-out. The Bank Board sees no justification for undermining the federal deposit insurance system in this manner.

I. Competitive Equity: One issue arising from the granting of assistance concerns whether to place restrictions on the ability of institutions receiving help to compete with those that are unsubsidized. Many institutions with substantial net worth fear they will be at a disadvantage relative to competitors backed by the federal government. In particular, they feel there will be a tendency by assisted associations to pay recklessly high rates on savings, or engage in extremely aggressive branching or advertising. While we feel the dimensions of the potential problem in general have been over-stated, we believe these concerns basically are reasonable and intend to administer any net worth program to assure fair treatment in this area. The Bank Board already has taken steps in this direction with respect to our Phoenix Program associations, which essentially are limited to non-aggressive, static-market-share operations--although the Phoenix model probably would be excessively conservative for an industry-wide plan. Because S. 2531 would cover only a fraction of an institution's losses, thus virtually eliminating incentives for risky behavior, the issue of competitive fairness presents itself most starkly with regard to H.R. 6267.

7. Comments on S. 2532

S. 2532, which Chairman Garn has introduced by request, contains various powers which the Bank Board and the FDIC believe would be extremely helpful in dealing with the current situation.

Because I have already provided testimony to this Committee on the powers contained in our proposal, I will keep any remarks on this measure very brief. With one exception, the provisions in the bill relating to the Bank Board are the same as those contained in the extraordinary powers provisions of S. 1703 and S. 1720.

That exception concerns the provision by the Bank Board of federal charters to mutual savings banks. Because important investment and other powers come with the granting of a federal charter, many savings banks have been eager to convert. Conversion also involves obtaining FSLIC insurance of accounts, however, and that requirement has been an obstacle for many savings banks. Although 12 U.S.C. § 1831c directs the FDIC to indemnify the FSLIC on a limited basis for losses attributable to converted savings banks, the Bank Board has regarded the statutory indemnification formula as inadequate, given the condition of many applicants and the pressures on the FSLIC.

Accordingly, in order to provide savings banks with a meaningful conversion option, the Bank Board and the FDIC have drafted provisions for your consideration that would enable savings banks to acquire federal charters from the Bank Board while retaining FDIC insurance. This, of course, is essentially the same situation that exists with respect to national banks, which are chartered by the Comptroller of the Currency and insured by the FDIC. The national bank analogy would be preserved on a supervisory level, as well, with the Bank Board acting as principal regulator. For the purposes of statutes such as the Community Reinvestment Act, Truth-in-Lending Act and Equal Credit Opportunity Act, FDIC-insured savings banks would be treated as FSLIC-insured institutions.

The FDIC would be able to make special examinations of the savings banks it insures and, of course, would receive necessary financial data concerning them from the Bank Board. It also could approve or disapprove mergers with non-FDIC-insured institutions, and would serve as receiver in the case of failure. In addition, in emergency situations it could, in effect, direct the Bank Board to issue a federal stock or mutual charter to prevent the closing of an FDIC-insured savings bank or to enable such a closed bank to reopen.

In terms of powers, FDIC-insured federal savings banks would operate on a par with existing federal savings banks, and would have to observe the special branching and diversification restrictions applicable to those institutions. Should a federal savings bank wish to transfer its deposit insurance coverage from the FDIC to the FSLIC, it would be able to do so, provided it satisfied entry requirements. No indemnification of the FSLIC by the FDIC would accompany such a change, however.

The Bank Board believes this approach to the problem of federal savings bank conversions is equitable and pragmatic. We hope that you will consider it favorably. As a final matter with regard to S. 2592, that bill contains a number of sections concerning FSLIC conservatorship and receivership powers over state-chartered institutions. We have agreed with state supervisory officials to modification of these provisions. We expect to have amendatory language available in the near future.

8. Conclusion

To conclude, Mr. Chairman, the thrift industry is undergoing a severe crisis. If rates improve over a significant period of time, we can handle our responsibilities with available resources. If they do not improve, the situation could require additional federal support. If Congress believes it would be proper and prudent to supply this federal support now or in the future, we believe S. 2531 represents an easily administrable, cost-effective, and market-disciplined approach that could avoid aggravating budget deficit problems, while buying time for large numbers of potentially viable thrift institutions. The Bank Board also believes you should give serious consideration to S. 2532. As we have testified in the past, by providing additional tools to the FDIC and the Bank Board, Congress would enable us to discharge our responsibilities in a more effective and economical fashion. Moreover, S. 2532 would permit us to make a reality of the federal charter option that Congress intended to give the savings bank industry by passing Title XII of Public Law 95-630. Finally, however, we must reemphasize our conviction that restructuring legislation should be enacted without delay. It offers the only real route to thrift survival. In fact, we believe that, if the assistance to the thrift industry Congress currently is contemplating is not accompanied by restructuring, then the federal monies expended will have been largely wasted.

Mr. Chairman, this concludes my remarks. I would be pleased to answer your questions.

Note: In accordance with 12 U.S.C. § 250, this statement has not been reviewed outside the Federal Home Loan Bank Board and does not necessarily reflect the views of the President.

The CHAIRMAN. Thank you, Chairman Pratt.

May I just comment that I certainly agree with you on the need for a more balanced package of short-term and long-term solutions. It has been just about exactly a year ago when we held extensive hearings in the subcommittee on the whole problem of the thrifts, and out of those thrifts came S. 1720, introduced in October.

At no time in my public career have I ever spent as much time on an issue as I have on the problems of the financial services industry or as much thought or study. And it's been a rather difficult year in some cases, because of those who would like to stay in the 1960's and 1970's, and I would too. It would be nice if we could go back and have everything very neatly compartmentalized, with thrifts making home loans, commercial banks and commercial lending business, Sears selling vacuum cleaners and washing machines, and Merrill Lynch in the securities business. But that is not the real world, as you have mentioned.

In excess of $200 billion in money market funds. That is real. It is a new competitive way of doing business. Consumers enjoy it. I don't begrudge them that at all. But I do think we've got to recognize the realities of the 1980's, and I say that, as I've said so many times, that I am not married to any particular provisions of S. 1720. I have no great pride of authorship. As a matter of fact, many of the provisions were introduced by other Senators on this committee. In previous times, it was a compilation of ideas from many members of this committee. Nothing is set in concrete or etched in stone in that legislation.

But the point about S. 2531 and S. 2532, even though I support them and introduce them, they are short term, and I believe we kid ourselves if that is all we do is another short term. We must do that. I agree with Senator Riegle. I hope we can do that by the end of June. It's necessary that we do so. I also hope that we can couple with that some longer term setting of policy, and this should not be done by the regulators. Too many times the regulators have been forced to take actions that we end up disapproving of, because we have not been willing to set policy on the legislative side here. So I'm hopeful that during the next month or so, too, that we can come to grips with the longer term solutions, and I'm please to say that since the hearings in October, and I'm very disappointed with the initial testimony groups, it seems to be so self-serving, but cooperation is much, much higher. Organizations like the U.S. Savings & Loan League, the ABA, have been talking to each other, and I do believe that we are getting close to where there is a general consensus on new powers and authority. The barriers are much softer than they were last fall, so maybe the effort has not been in vain.

And I do feel more hopeful now that during this year we will be able to achieve some long-term restructuring. I'm more confident of that than at any time since this process started more than a year ago.

So I thank you for your strong testimony on the need for combining the short-term with the long-term solution.

Chairman Isaac.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Isaac. Mr. Chairman, members of the committee, we appreciate this opportunity to present our views and applaud your efforts in presenting this legislation.

REGULATORS' BILL

On October 30, 1981, we appeared before you to urge enactment of the regulators' bill and to support a variety of new asset powers embodied in S. 1920. Five days later on November 4, 1981, one of the greatest tests in the FDIC's 48-year history began with the merger of the Greenwich Savings Bank into the Metropolitan Savings Bank at an estimated potential cost to the FDIC of $421.5 million. This single transaction obligated more money than we had spent in handling the 575 previous bank failures in the history of the Corporation.

Since then we have handled eight additional large savings bank failures at a total estimated cost, including the Greenwich transaction, of $1.7 billion. In addition, so far this year we've handled 11 commercial bank failures.

Even under the most optimistic projections for declining interest rates, the probability of additional assisted mergers is high.

We worked diligently in handling the nine savings bank failures and utilized the most efficient, cost-effective means at our disposal to resolve the problems.

In seven of the nine cases, the resolution involved a merger with another thrift entity. In every case an in-State bidder was the acquiring party.

The process has not been easy. Limitations on our ability to bring an adequate number of potential acquirers into the bidding process have made it extraordinarily difficult to find effective solutions to individual problems.

In three instances, with the blessing of cooperative State legislatures and/or State bank supervisors, we have entertained interstate proposals.

Although we finally handled these three problems on an in-State basis, the mere existence of the interstate bidders reduced our costs by more than $100 million.

High interest rates are having a devastating impact on thrift earnings, are eroding the deposit base of all depository institutions and are contributing to an increase in nonperforming loans.

We must have regulatory and legislative changes to permit depository institutions to compete in today's markets and to give us greater flexibility to address problems as they arise.

You've asked us to testify on two proposals—a revised regulators' bill and the Capital Assistance Act of 1982. The regulators' bill, in particular, will enhance our ability to meet the challenge of failing institutions.

However, this is only a solution to our most immediate, serious problems. The need remains for long-run structural reform which can be accomplished through deposit interest rate deregulation, new asset powers as set forth in S. 1720, and legislation to preempt State usury statutes and due-on-sale clause prohibitions.

Some people question the need for a regulators' bill, observing that we always seem to find a way to carry out our responsibilities under existing law. We have been fortunate up to this point. We had a State legislature pass emergency legislation on 4 days' notice in one instance—a truly remarkable feat. In several situations, when things have looked their bleakest, with a major problem at hand and no good solution in sight, an acquirer has finally appeared with an acceptable proposal.

This can't continue indefinitely. With each transaction our options for resolving the next problem are narrowed.

The amendments to section 13 of the FDIC Act will provide greatly needed flexibility. We have expanded the proposal introduced last year to cover not only a failed bank that is closed and placed in receivership, but also an insured bank in danger of failure.

Our experience indicates that it's generally preferable to avoid the actual closing of a mutual institution. The threshold size for employing interstate bidding has been lowered from $2 billion to $500 million in assets.

One major change in S. 2532 from the earlier version is that the FDIC and the Federal Home Loan Bank Board have reached agreement on the problem of indemnification in the case of savings bank conversions from State to Federal charter.

S. 2532 still contains an amendment to section 13 of our act to facilitate direct financial assistance where appropriate. We believe this authority is preferable to the proposal contained in section 3 of S. 2531.

The Section 13(c) language is broader as to the form of assistance. Furthermore, it is not limited to any percentage of the bank's previous losses. This combination gives us the flexibility to tailor the aid to meet the needs of a specific institution and provide enough assistance to redirect it on a path to profitability.

Our objective in handling the nine assisted mergers to date has been to insure that the surviving institutions are viable. We would want to achieve the same objective through any capital assistance program.

In our judgment, the type of assistance available under the formula in S. 2531 would not achieve this result and would not be particularly helpful to us or the savings bank industry.

However, our interpretation of other provisions in S. 2531 is that we need not adhere to the formula but could provide such assistance as we believe appropriate.

This flexibility is most desirable, and we commend you for providing this alternative. We would note that the cap on the assistance—100 percent of an institution's losses in the immediately preceding period—might be unduly restrictive in some situations and we would recommend its deletion.

We recognize that if the problems in the savings bank industry continue to grow it might not always be feasible or desirable to arrange a merger even with the availability of the interstate bidding option.

It is for this reason that we requested the amendment to section 13(c) of our act to give us greater flexibility to provide direct financial aid.

MERGERS

However, in general, we believe mergers are preferable to direct financial aid where they can be arranged with a comparatively strong institution at a reasonable cost.

Our most recent assisted savings bank merger will, I believe, illustrate the relative merits of the merger approach, as contrasted with the alternative of direct financial assistance.

In evaluating the merger proposals we received from the Western Savings Fund Society in Philadelphia, our staff calculated the estimated cost of providing sufficient direct financial assistance under section 13(c) of our act to absorb Western's projected losses over a 10-year period assuming continuation of current interest rate levels.

The estimated cost on a present value basis for the FDIC just to stabilize Western came to $280 million. Using the same interest rate assumptions, we estimated the cost of our assistance agreement with the Philadelphia Saving Fund Society, which acquired Western, at $294 million.

While the estimated cost of the merger was slightly higher than the estimated cost of direct assistance, the difference was not great and was, we believe, well worth it.

First, direct assistance to Western would not have resulted in a stronger institution. At the time of the merger, Western had all but exhausted its surplus account. Break-even assistance would have done nothing to alter that, and at the end of the 10-year period the institution would still have had virtually no surplus.

In other words, while it would have been kept alive for the duration of the assistance period, once the assistance was terminated, Western would have found itself in a precarious position for many years to come.

Second, because a significant amount of FDIC oversight is a sine qua non of direct assistance, Western would have been burdened with FDIC-imposed management and operating controls for the duration of the assistance.

Not only is the notion of such direct government involvement philosophically distasteful, it could have detrimental practical effects.

Third, Western would have had difficulty in retaining its present management and would have found it virtually impossible to attract competent recruits.

If you are a bright young MBA, do you choose to join an institution limping along on a government subsidy or do you go elsewhere?

Fourth, significant economies will be achieved as a result of the PSFS merger. Redundant branch offices will be closed and duplicate operations will be curtailed.

The point is, sufficient direct assistance to stabilize Western could have been provided at a cost comparable to that of an assisted merger, but the result would have been a very marginal institution with a limited ability to attract and retain good management, whose capacity to grow and serve its community would be severely hampered—in short, a financial cripple.

Instead, we chose to merge Western into PSFS and provided sufficient assistance to insure that the acquisition did not weaken PSFS. The result was a stronger institution with the ability to effect numerous efficiencies, to grow and prosper without government interference, and consequently to better serve the people of Philadelphia. To us, that was an obviously preferable solution.

In total we estimate that the assisted mergers to date will cost the FDIC approximately $1.7 billion over the life of the assistance agreements, assuming that interest rates remain at their current levels.

This sum is approximately the same as our estimate of the amount of direct financial assistance that would have been required to simply stabilize these failing institutions under the same interest rate assumptions.

Mr. Chairman, the problems in the savings bank industry are real and can only be corrected through real solutions. Our strategy in addressing problems has been to arrange assisted mergers with the most solid institutions available at a reasonable cost. We have given sufficient assistance to insure that the acquiring firms remain strong.

We are convinced that the public has been well served by these nine assisted mergers. We are equally convinced that the savings bank industry is stronger as a result.

We have the financial and personnel resources to continue to meet the savings bank challenge squarely. We are not asking for money. All we ask is that we be given the statutory flexibility necessary to do the job as it should be done.

I thank you again for this opportunity to present our views. I'd like to request that my full remarks be made part of the record.

[The complete statement follows.]

STATEMENT OF

WILLIAM M. ISAAC, CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman and Members of the Committee:

We appreciate this opportunity to present the FDIC's views on pending bills S. 2531 and S. 2532.

On October 30, 1981, we appeared before you to urge enactment of the "Regulators' Bill" and to support the variety of new asset powers embodied in S. 1720. Five days later on November 4, 1981, one of the greatest tests in the FDIC's 48-year history began with the merger of the Greenwich Savings Bank into the Metropolitan Savings Bank at an estimated potential cost to the FDIC of $421.5 million. This single transaction obligated more money than we had spent in handling the 575 previous bank failures in the history of the Corporation.

Since then we have handled eight additional large savings bank failures at a total estimated cost, including the Greenwich transaction, of $1.7 billion. In addition, so far this year we have handled 11 commercial bank failures. Even under the most optimistic projections for declining interest rates, the probability of additional assisted mergers is high.

Our comments this morning are based in large measure on the experience of these past months. We would like to share some of that experience with you.

We worked diligently in handling the nine savings bank failures and utilized the most efficient, cost-effective means at our disposal to resolve the problems. In seven of the nine cases, the resolution involved a merger with another thrift entity. In every case an in-state bidder was the acquiring party.

The process has not been easy. Limitations on our ability to bring an adequate number of potential acquirers into the bidding process have made it extraordinarily difficult to find effective solutions to individual problems.

In three instances, with the blessing of cooperative state legislatures and/or state bank supervisors, we have entertained interstate proposals. Although we finally handled these three problems on an in-state basis, the mere existence of the interstate bidders reduced our costs by more than $100 million.

High interest rates are having a devastating impact on thrift earnings, are eroding the deposit base of all depository institutions and are contributing to an increase in non-performing loans. We must have regulatory and legislative changes to permit depository institutions to compete in today's markets and to give us greater flexibility to address problems as they arise.

You have asked us to testify on two proposals -- a revised Regulators' Bill and the Capital Assistance Act of 1982. The Regulators' Bill, in particular, will enhance our ability to meet the challenge of failing institutions. However, this is only a solution to our most immediate, serious problems. The need remains for long-run structural reform which can be accomplished through deposit interest rate deregulation, new asset powers as set forth in S. 1720, and legislation to preempt state usury statutes and due-on-sale clause prohibitions.

Prior to last December's DIDC meeting, DIDC members were subjected to intense pressures to delay the course of deregulation Congress had charged us to carry out. The Committee did delay, after which I wrote that the one course we simply could not afford to follow was maintenance of the status quo. Now, five months later, little has happened except that we have obligated another billion dollars to assist failing savings and commercial banks, not to mention the S&L experience.

We believe the time has come for Congress to make the hard choices needed to preserve and strengthen our depository institutions in today's climate and to prepare them for tomorrow. In our judgment, this should be accompanied by the DIDC's authorization of an instrument that is truly competitive with the money market funds, returning funds to our banks and thrifts to finance homes, cars, farms and businesses.

The Regulators' Bill, which we submitted to you last year for inclusion in S. 1720, was essentially drafted two years ago in anticipation of forthcoming problems. The version submitted jointly with the Federal Home Loan Bank Board last week -- S. 2532 -- has been modified based on our actual experiences.

Some people question the need for this legislation, observing that we always seem to find a way to carry out our responsibilities under existing law. We have been fortunate up to this point. We had a state legislature pass emergency legislation on four days' notice in one instance, a truly remarkable feat. In several situations, when things have looked their bleakest -- with a major problem at hand and no good solution in sight -- an acquirer has finally appeared with an acceptable proposal. This cannot continue indefinitely; with each transaction our options for resolving the next problem are narrowed.

The amendments to Section 13 of the FDI Act will provide greatly needed flexibility. We have expanded the proposal introduced last year to cover not only a failed bank that is closed and placed in receivership but also an insured bank in danger of failure. Our experience indicates it is generally preferable to avoid the actual closing of a mutual institution. The threshold size for employing interstate bidding has been lowered from $2 billion to $500 million or more in assets.

One major change in S. 2532 from the earlier version is that FDIC and the Federal Home Loan Bank Board have reached agreement on the problem of indemnification in the case of savings bank conversions from state to federal charter. Under the provisions of S. 2532, the FDIC would continue as the insurer of the converted savings bank but the Bank Board would be the bank's regulator. The bank's relationship with the FDIC would be the same as that of a national bank. In the event of a failure, the FDIC would be appointed receiver. We and the Bank Board believe this is a perfectly workable arrangement which meets every legitimate interest and concern of the savings bank industry.

S. 2532 still contains an amendment to Section 13(c) of our Act to facilitate direct financial assistance where appropriate. We believe this authority is preferable to the proposal contained in Section 3 of S. 2531. The Section 13(c) language is broader as to the form of assistance. Furthermore, it is not limited to any percentage of the bank's previous losses. This combination gives us the flexibility to tailor the aid to meet the needs of a specific institution and provide enough assistance to redirect it on a path to profitability.

Mr. Chairman, we would have no objection to the enactment of S. 2531, although as I have just noted, we prefer the Section 13(c) amendment in S. 2532. It is our judgment that assistance in the amounts specified by the formula set forth in S. 2531 would slow the rate of decline of a money-losing institution, but for most institutions it would neither halt the losses nor give management any real opportunity to restructure assets.

Our objective in handling the nine assisted mergers to date has been to insure that the surviving institutions are viable. We would want to achieve

the same objective through any capital assistance program. In our judgment, the type of assistance available under the formula in S. 2531 would not achieve this result and would not be particularly helpful to us or the savings bank industry. However, our interpretation of other provisions in S. 2531 is that we need not adhere to the formula but could provide such assistance as we believe appropriate. This flexibility is most desirable and we commend you for providing this alternative. We would note that the cap on the assistance -- 100 percent of an institution's losses in the immediately preceding period -- might be unduly restrictive in some situations and we would recommend its deletion.

We recognize that if the problems in the savings bank industry continue to grow it might not always be feasible or desirable to arrange a merger even with the availability of the interstate bidding option. It is for this reason that we have requested the amendment to Section 13(c) of our Act to give us greater flexibility to provide direct financial aid. However, in general we believe mergers are preferable to direct financial aid where they can be arranged with a comparatively strong institution at a reasonable cost.

Our most recent assisted savings bank merger will, I believe, illustrate the relative merits of the merger approach as contrasted with the alternative of direct financial assistance. In evaluating the merger proposals we received for the Western Savings Fund Society in Philadelphia, our staff calculated the estimated cost of providing sufficient direct financial assistance under Section 13(c) of our Act to absorb Western's projected losses over a 10-year period assuming continuation of current interest rate levels. The estimated cost, on a present value basis, for the FDIC just to stabilize Western came

to $280 million. Using the same interest rate assumptions, we estimated the cost of our assistance agreement with Philadelphia Saving Fund Society (PSFS), which acquired Western, at $294 million. While the estimated cost of the merger was slightly higher than the estimated cost of direct assistance, the difference was not great and was, we believe, well worth it.

First, direct assistance to Western would not have resulted in a stronger institution. At the time of the merger, Western had all but exhausted its surplus account. Break-even assistance would have done nothing to alter that, and at the end of the 10-year period the institution would still have had virtually no surplus. In other words, while it would have been kept alive for the duration of the assistance period, once the assistance was terminated Western would have found itself in a precarious position for many years to come.

Second, because a significant amount of FDIC oversight is a sine qua non of direct assistance, Western would have been burdened with FDIC-imposed management and operating controls for the duration of the assistance. Not only is the notion of such direct government involvement philosophically distasteful, it could have detrimental practical effects.

Third, Western would have had difficulty retaining its present management and would have found it virtually impossible to attract competent recruits. If you are a bright young MBA, do you choose to join an institution limping along with a government subsidy or do you go elsewhere?

Fourth, significant economies will be achieved as a result of the PSFS merger. Redundant branch offices will be closed and duplicate operations will be curtailed.

The point is, sufficient direct assistance to stabilize Western could have been provided at a cost comparable to that of an assisted merger, but the result would have been a very marginal institution with a limited ability to attract and retain good management, whose capacity to grow and serve its community would be severely hampered -- in short, a financial cripple. Instead, we chose to merge Western into PSFS and provided sufficient assistance to insure that the acquisition did not weaken PSFS. The result was a stronger institution with the ability to effect numerous operating efficiencies, to grow and prosper without government interference and, consequently, to better serve the people of Philadelphia. To us, that was an obviously preferable solution.

In total we estimate that the assisted mergers to date will cost the FDIC approximately $1.7 billion over the life of the assistance agreements, assuming interest rates remain near current levels. This sum is approximately the same as our estimate of the amount of direct financial assistance that would have been required to simply stabilize these failing institutions under the same interest-rate assumptions.

Mr. Chairman, the problems in the savings bank industry are real and can only be corrected through real solutions. Our strategy in addressing problems has been to arrange assisted mergers with the most solid institutions available at a reasonable cost. We have given sufficient assistance to insure that the acquiring firms remain strong.

We are convinced that the public has been well served by these nine assisted mergers. We are equally convinced that the savings bank industry is stronger as a result.

We have the financial and personnel resources to continue to meet the savings bank challenge squarely. We are not asking for money. All we ask is that we be given the statutory flexibility necessary to do the job as it should be done.

The CHAIRMAN. Mr. Conover?

STATEMENT OF C. TODD CONOVER, COMPTROLLER OF THE CURRENCY

Mr. CONOVER. Mr. Chairman, members of the Committee, I am pleased to offer the views of the Comptroller's Office on the important legislative initiatives before you today. I would like to begin by describing my understanding of the problems confronting depository institutions.

These problems are severe; they affect both banks and thrifts, and they are not transitory.

While some of the pressures are short-term and may be mitigated by lower interest rates or an upturn in the economy, others will continue as the industry changes from a regulated to a competitive environment.

Before discussing my recommendations on the legislation before the committee, let me briefly elaborate on these observations. As you know, there are many pressures facing depository institutions today. Hopefully two of them will be mitigated as economic conditions improve.

PROBLEMS CONFRONTING DEPOSITORY INSTITUTIONS

The first is the impact on earnings of a rapid increase in interest rates on a maturity mismatched portfolio like that of most thrift institutions and some commercial banks.

The second problem is the decline in the quality of assets in loan portfolios. A growing number of companies, both large and small, are experiencing financial difficulties, including bankruptcies. A decline in interest rates and an economic upturn would alleviate these problems, but some institutions have already been so weakened that they may not survive.

Three other serious problems will be faced by depository institutions for quite some time, however. These are the loss of low cost deposits, high operating costs, and nonregulated competition.

Core deposits with regulated interest rate ceilings have provided a subsidy that has been the source of a substantial portion of depository institution profits. Today they are faced with a loss of this subsidy, and that loss is virtually irreversible, regardless of the deregulatory approach.

Either core deposits will cost more as interest rate ceilings are lifted, or core deposits will leave the institution as customers seek higher rates elsewhere, thus forcing the institution to purchase market rate funds to replace them.

Furthermore, a decline in interest rates from today's levels will not eliminate the incentive of depositors to shift out of five and a quarter or five and a half percent passbook accounts, unless market rates decline to that range.

While the official deregulation of deposit rate ceilings is occurring at a slow pace, market deregulation of deposit costs, spurred by consumer demands for higher returns, is occurring quite rapidly. But asset deregulation is still awaiting congressional action, and continued inaction could substantially weaken our depository system.

The profitability of depository institutions has been further eroded by a dramatic increase in operating costs. These costs are an unfortunate legacy of a regulated environment that encouraged service competition and inflation that drove salaries and expenses up.

This high cost structure poses a serious competitive problem and one that cannot easily or quickly be overcome. These internal pressures are exacerbated by increased competition from other less regulated financial service companies with lower cost structures. Some of them are far better situated than our banking institutions to reach and service the developing national marketplace.

The legislative proposals that are the focus of these hearings provide the regulatory authorities with broader powers to assist weakened institutions through a capital assistance program and to authorize mergers across industry and State lines in extraordinary circumstances.

While we support such legislation, alone it will accomplish little.

Legislative efforts should also address some of the fundamental earnings problems that I have described and allow institutions greater flexibility to compete.

EXPANDED POWERS

S. 1720 as proposed by Chairman Garn would expand the asset powers of thrift institutions. These expanded powers are a necessary component of any legislative solution to the current thrift problem. The phase-out of deposit rate controls, already underway, must be matched by an accompanying expansion of asset powers to enable depository institutions to adjust to deregulation and avoid earnings problems in the future.

It is also very important to banks and thrifts to be able to appropriately price loans acquired under existing powers. An override of State usury laws and due-on-sale prohibitions is essential to alleviate the problem of narrowing interest rate spreads when interest rates rise.

Furthermore, these restrictions disrupt credit markets and often limit the availability and increase the price of credit to consumers.

To enable commercial banks to compete more effectively, we also support title II of S. 1720, especially amendments to 12 U.S.C. 371, 84 and 82.

Section 371 currently imposes rigid limitations on real estate lending by national banks. In order to play a greater role in the changing real estate and financing market, national banks must be able to offer more creative and flexible financing arrangements. The proposed revisions to 371 would permit them to do so.

The legal lending limits established by section 84 are increasingly burdensome and should also be amended. Smaller banks, particularly those in rapidly growing areas and those serving agricultural customers, are limited by that law in their ability to meet local credit needs and to compete with State bank and non-bank competition.

Section 82, borrowing limitations, should also be amended to allow banks to use liability management techniques more effectively.

As described earlier, the replacement of core deposits with purchased funds is a growing trend, and existing borrowing limitations which hamper banks' ability to soundly manage their liability structures must be revised.

We also support the enactment of authority for banking organizations to offer increased securities and securities-related services. Unless banking entities are granted broader authority, the increasing regulatory imbalance between them and non-depository institutions will have significant adverse consequences on the commercial banking industry.

Even if these powers are enacted, though, some governmental action may be necessary to assist distressed institutions during the current adverse economic conditions and to bridge the transition period to a more competitive environment.

One such initiative is S. 2532, the so-called Revised Regulators' bill. The Federal supervisory agencies need that bill to deal with troubled institutions—and we strongly support it.

First, that bill would grant the FSLIC and FDIC substantially similar authority to assist distressed situations. More importantly, it would expand the FDIC's options in dealing with troubled banks before they reach such a deteriorated condition that merger assistance is too expensive or direct aid is of little help in preserving the bank's viability.

The bill would also authorize regulators to permit cross-industry and interstate mergers of threatened institutions in certain cases. In many circumstances, such mergers are necessary because there is no other reasonable alternative.

We prefer the extraordinary merger provisions of S. 2532 to the House-passed bill. In particular, the Senate proposal would permit the agencies to approve interstate sales of large, failing commercial banks, as well as thrifts, in such extraordinary circumstances.

While we prefer the lower asset threshold of $500 million for commercial and savings banks in the Senate version, we question whether or not any minimum should be specified.

We also endorse the Senate bill's omission of new branching restrictions on thrift institutions that may be acquired under extraordinary circumstances. Such restrictions would both reduce their attractiveness as merger partners and also hamper their continued viability in their established market areas.

TIERED BIDDING

The tiered bidding concept, however, which is part of both the House and Senate bills, should not, in our view, be mandated. In attempting to apply similar bidding practices in recent transactions, the FDIC has found that such a tiered procedure is both costly and unworkable.

Potential out-of-State acquirers are discouraged from participating aggressively in the bidding process because of the likelihood that their bids will be "shopped" in-State.

A tiered bidding approach would only give the appearance of increasing regulatory options. It actually would do little to alleviate the problem.

The proposed capital assistance program contained in S. 2531 is essentially an interim measure to enable well-managed institutions to survive so that they can compete in the future.

We believe that S. 2531 is superior to the approach adopted by the House. Among other things, the percentage-of-loss approach and the use of the same eligibility criteria for all institutions—rather than a more lenient standard for commercial banks—are preferable.

We also endorse the override of laws that impose criminal liability on directors who accept deposits when statutory net worth has fallen below a specified level.

We do not believe, however, that Federal assistance should be linked to the level of any particular type of loan previously made or to be made by a participating institution. Such a link would amount to credit allocation, which is in part the cause of our present problems.

This program does create some potential for overlap between the authority of the FDIC and the Comptroller's Office with regard to participating national banks. I trust, however, that in cooperation with the FDIC we will be able to work with the committee in honing the finer details of this program.

In summary, our entire depository system has been weakened by high interest rates and faces continued pressures during the transition to a deregulated environment.

S. 2531 and S. 2532 and the provisions of S. 1720 that I have mentioned would form an attractive package to deal with these problems. We support them.

Thank you, Mr. Chairman.

[The complete statement follows:]

STATEMENT OF

C. T. CONOVER

COMPTROLLER OF THE CURRENCY

BEFORE THE COMMITTEE ON BANKING,

HOUSING AND URBAN AFFAIRS

U.S. SENATE

MAY 26, 1982

Mr. Chairman, Members of the Committee, I am pleased to offer the views of the Office of the Comptroller of the Currency on the important legislative initiatives before you today. Since this is my first time to testify on these issues, I would like to begin by describing my understanding of the problems confronting depository institutions. In particular, I wish to make the following points:

- The problems are severe.
- They affect both banks and thrifts.
- They are not transitory; while some of the pressures are short-term and may be partially mitigated by lower interest rates or an economic upturn, others will continue as the industry changes from a regulated to a competitive environment.

Before discussing my recommendations on the legislation before the Committee, let me briefly elaborate on these observations.

THE FINANCIAL MARKETPLACE IN TRANSITION

There are many pressures facing depository institutions today. Two key ones are well-known to this Committee and hopefully will be mitigated as economic conditions improve. The first is the impact on earnings of a rapid increase in interest rates on a maturity-mismatched portfolio like that of most thrift institutions and some commercial banks. The second problem is the decline in the quality of depository institutions' assets. A growing number of companies -- large and small -- are experiencing financial difficulties, including bankruptcies. A decline in interest rates and an economic upturn would alleviate both these problems, although some depository institutions have already been so weakened that they may not survive.

Three even more serious problems will be faced by depository institutions for quite some time, however. These are:

- loss of low-cost deposits,
- high operating costs, and
- non-regulated competition.

Controlled low-cost core deposits have provided an effective subsidy in recent years that has been the source of a substantial portion of depository institutions' profits. Depository institutions are faced with a loss of this subsidy, which is virtually irreversible regardless of the deregulatory approach. Either core deposits will cost more as interest rate ceilings are lifted, or core deposits will leave the institution as customers seek higher rates elsewhere, forcing the institution to purchase market-rate funds. Furthermore, a decline in interest rates from today's

levels will not eliminate the incentive of depositors to shift out of a 5-1/2 percent account, unless market rates decline to that range.

While Congressionally mandated deregulation of deposit rate ceilings is occurring at a slow pace, marketplace deregulation of deposit costs, spurred by consumer demands for higher returns, is occurring quite rapidly. So-called "sweep accounts" are a prime example of this phenomenon. But asset deregulation for depository institutions is, for the most part, still awaiting Congressional action. As a result, interest rate spreads are narrowing and severe pressure is being felt on earnings. Continued inaction could substantially weaken our depository system.

The profitability of depository institutions has been further eroded by a dramatic increase in operating costs -- both in absolute amounts and in proportion to assets. These costs are an unfortunate legacy of a regulated environment that encouraged service competition rather than price competition, and inflation that drove salaries and expenses up. This high cost structure poses a serious competitive problem to depository institutions -- one that they cannot easily or quickly overcome.

These internal pressures are exacerbated by increased competition from other less regulated financial service companies, unburdened by high operating costs and unfettered by asset restrictions. Some of those companies are far better situated than our largest banking institutions to reach and service the developing national marketplace.

LEGISLATIVE RESPONSES

The legislative proposals that are the focus of these hearings provide the regulatory authorities with broadened powers to assist weakened

institutions through a capital assistance program and to authorize mergers across industry and state lines in extraordinary circumstances. While we support such emergency legislation, alone it will accomplish little. Legislative efforts should also address some of the fundamental earnings problems that I have described and allow institutions greater flexibility to compete.

Expanded Thrift Asset and Liability Powers

S. 1720, as proposed by Chairman Garn, would expand the asset powers of thrift institutions. These expanded powers are a necessary component of any legislative solution to the current thrift problem. The phase-out of deposit rate controls, already under way, must be matched by an accompanying expansion of asset powers to enable depository institutions to avoid a recurrence of their earnings problems. The authority to accept demand deposits from all customers and to invest in commercial, agricultural and consumer loans would provide thrift institutions with much-needed flexibility.

Usury and Due-on-Sale Provisions

However, of even greater near-term importance for depository institutions is the ability to appropriately price assets acquired under existing powers. An override of state usury laws and due-on-sale prohibitions is essential to alleviate the fundamental problem of narrowing interest spreads whenever rates rise. Furthermore, these restrictions disrupt the credit markets, and often limit the availability and increase the price of credit to consumers.

Deregulation of Bank Powers

To enable commercial banks to compete more effectively, we also support Title II of S. 1720, especially amendments to 12 U.S.C. §§ 371, 84, and 82.

Section 371, the statute governing national bank real estate lending, currently imposes rigid limitations such as loan-to-value ratios and amortization requirements. In order to play a greater role in the changing real estate financing market, national banks must be able to offer more creative and flexible financing arrangements. The proposed revisions to Section 371 would better allow them to do so.

The legal lending limits established by Section 84 are increasingly burdensome and should be amended. Smaller banks in rapidly growing areas and those serving agricultural customers are limited by that law in their ability to meet local credit needs. National banks increasingly vie for customers with non-bank competitors and state banks that often are not as constrained by such limits.

Section 82 borrowing limitations should also be amended to allow banks to use liability management techniques more effectively. The replacement of core deposits with purchased funds is, as described earlier, a growing trend. This trend underscores the need to provide national banks with greater flexibility to manage their liabilities. Existing borrowing limitations, which hamper their ability to do so, must be revised.

We also support the enactment of authority for banking organizations to offer increased securities and securities-related services. In recent years, the product segmentation mandated by the Glass-Steagall Act has been eroded by non-depository institutions offering new financial products

and services. Unless banking entities are granted broader authority, the increasing regulatory imbalance will have significant adverse consequences for the commercial banking industry.

Bridging the Transition Period

Even if these powers are enacted, some governmental action may be necessary to assist distressed institutions during the current adverse economic conditions and to bridge the longer transition period from a heavily regulated to a more competitive environment.

The Regulators' Bill

One such initiative is S. 2532, the so-called revised Regulators' Bill. The federal supervisory agencies need increased regulatory flexibility to deal with troubled institutions. As described earlier, all depository institutions can expect to experience continuing earnings pressure for perhaps several years. As a result, federal supervisory authorities must have permanent authority to address problems. We, therefore, strongly support the provisions of proposed S. 2532, which provide various extraordinary supervisory authority to the agencies.

First, that bill would grant the FSLIC and FDIC substantially similar authority to assist distressed depository institutions. More importantly, provisions of S. 2532 would expand the FDIC's options in dealing with troubled institutions before they reach such a deteriorated condition that merger assistance is too expensive or direct aid is of little help in preserving the recipient bank's viability.

The bill would also authorize the FSLIC and FDIC to permit cross-industry and interstate mergers of threatened institutions in certain cases. In many circumstances, such mergers are necessary because there is no other reasonable alternative. We greatly prefer the extraordinary merger provisions of S. 2532 to the House-passed bill. In particular, the Senate proposal would permit the agencies to approve interstate sales of large failing commercial banks, as well as thrifts, in such extraordinary circumstances. While we prefer the lower asset threshold of $500 million for commercial and savings banks in the Senate version, we question whether or not any minimum needs to be specified.

We also endorse the Senate bill's omission of new branching restrictions on thrift institutions that may be acquired under extraordinary circumstances. Limiting the ability of such institutions to compete effectively by restricting them to the branching limitations imposed on banks not only would reduce their attractiveness as merger partners, but also would hamper their continued viability in their established market areas.

The tiered bidding concept, however, which is a part of both the House and Senate bills, should not be statutorily mandated. In attempting to apply similar bidding practices in several recent transactions, the FDIC has found that such a tiered procedure is both costly and unworkable. Potential out-of-state acquirers are discouraged from participating aggressively in the bidding process, because of the likelihood that their bid will be "shopped" in-state. The statutory provisions as contained in H.R. 4603 would make this problem worse. A tiered bidding approach would

only give the appearance of increasing regulatory options; it would, however, do little to alleviate the regulatory agencies' problems.

Capital Assistance Proposals

The proposed capital assistance program contained in S. 2531 is essentially an interim measure to enable well-managed institutions to adjust and better compete in the future.

We believe that S. 2531 is superior to the approach adopted by the House. Among other things, the percentage-of-loss approach and use of the same eligibility criteria for all institutions (rather than a more lenient standard for commercial banks) are preferable. We also endorse the override of laws imposing criminal liability on directors who accept deposits after an institution's statutory net worth has fallen below a specified level, notwithstanding regulatory guarantees of net worth.

We do not believe, however, that federal assistance should be tied to the level of any particular type of loan previously made or to be made by a participating institution; such tying would amount to credit allocation that is in part the cause of our present problems.

Finally, because the legislation would apply to commercial banks, clarification is needed of several technical aspects of the proposed program as it would affect national banks. This program creates some potential for overlap between the authorities of the FDIC and the OCC with regard to participating national banks. I trust that in cooperation with the FDIC we will able to work with the Committee in honing the finer details of this program.

CONCLUSION

In summary, our entire depository system has been weakened by continuing high interest rates and faces continued pressures during the transition to a deregulated environment. Temporary federal assistance to endangered institutions, as proposed in S. 2531, may be justified at this time; however, such assistance is not a solution to fundamental problems.

I strongly encourage the Congress to act to restore the long-term health of our depository institutions by providing adequate asset and liability powers. We, therefore, strongly endorse the enactment of the major deregulatory provisions contained in S. 1720.

Finally, we encourage the Congress to enact S. 2532, the so-called revised Regulators' bill, to permit the federal supervisory agencies to better maintain confidence in our depository system.

I would be happy to answer any questions.

The CHAIRMAN. Thank you very much, gentlemen.

THRIFTS MANAGEMENT

Chairman Pratt, although the prospects for the thrifts in 1982 are certainly very much dependent upon what happens to interest rates, what do you believe that thrift managers can be doing for themselves to slow their problems down to increase their life expectancy? Do you think that management tools can be used to increase their life expectancy in any significant degree?

Mr. PRATT. Yes.

We have seen—certainly in the better managed institutions—a real attempt to deal with their own problems. And it's interesting to note that, even given the tremendous financial pressures which have occurred, some institutions have been successful even in these time periods. We see different models, but the successful institutions all enjoy excellent management. I think that clearly is a key.

However, I think the difficult times that we're presently experiencing are bringing forth, in many instances, the best that management can offer. We are seeing people who may not have been so innovative in the past being innovative in examining their cost structure, looking at the branch network, moving back from the idea that previously existed in financial institutions under a period of substantial protection, that growth was automatically good. And we're seeing more careful management of resources, a better allocation of funds, things of this type.

The Board has also taken some fairly aggressive steps in deregulting the ability of managers to manage, letting them borrow ı and where they see fit, not setting regulations on the maturi- of their borrowing, allowing them to use futures markets

where it can reduce risk in the institutions, authorizing the variable rate mortgage and so forth.

There are a number of institutions that are doing an excellent job of coping in very difficult circumstances and are going to be successful regardless of what happens.

The CHAIRMAN. I'm sure you would agree with what Senator Riegle said, that the vast majority of the institutions are well managed. Those who are not are in the minority.

But let me ask you this hypothetical situation. Assume that you were president of a thrift institution and we passed capital maintenance legislation that simply said, "All right, we'll take care of you at 2 percent for 2 years." What does that do to your incentive to help yourself to manage more carefully?

Mr. PRATT. Well, one thing that concerns us, if we're talking about simply a coverage of all losses, we're very concerned that that doesn't provide the proper signals or incentives. We foresee some instances, of course, where institutions' management would merely take that time to take advantage of the 2-year extension.

We already have seen some things that we call "last play action," where people have tried to take advantage of what is a very difficult situation.

Managers who have the incentives and ability to attempt survival will use that time very profitably, I think, in trying to restructure their portfolios, or, if they see themselves as not independently viable, trying to find the optimum combination with another institution which will make for a strong institution which is viable.

ASSUMING GUARANTEES

The CHAIRMAN. Would it seem to you, assuming absolute guarantees of losses at a certain level, that in the long run we simply would not be doing the thrifts a favor?

Mr. PRATT. Absolutely. I think it may be the greatest disservice that could possibly be done to this industry. There's a certain amount of euphoria that goes along with any assistance program like this. There are not many special interest groups that are opposed to the passage of a program of this type. But that euphoria, in my opinion, is going to disappear rather quickly after this is passed.

We're going to have 1,000 or 2,000 institutions which are being assisted and which are competing with unassisted institutions. We're going to have other competitors outside of this industry. When they see a branch application come in from an assisted institution, are going to send a letter to you and say, "How can you let a regulatory agency approve a branch or an institution which is being supported by the U.S. Government when I have to compete with them?" It's going to cause a division in the industry.

Unless this is combined with a positive package to move this industry forward, I think it's going to have a long-run effect which is very questionable.

The CHAIRMAN. Does it strike you to be rather odd that there are a lot of legislators who are clamoring for Federal assistance or Federal programs to help the thrifts and yet at the same time are not

willing to agree to legislation that would let the thrifts help themselves?

What I'm specifically referring to is what you talked a great deal about in your testimony. If we passed the capital assistance program, the regulators' bill, without including expanded asset powers, aren't we simply saying to them that "You must continue with all your eggs in one basket. That's the reason you're in trouble now, because you've been required by laws over the years to do this and that by congressional action. And we are guaranteeing that you will keep your eggs in the same basket and continue to have the same problems in the future"? Therefore, we're really legislating the thrifts out of business if we take the narrow approach.

Mr. PRATT. I believe that's true. I think that an aggressive capital maintenance program, combined with nothing else, is merely a blueprint for the long-term liquidation of this industry, that it has precisely the wrong effects, and that it is going to assure the failure of this industry and the inability of it to be competitive.

I suppose the cynical view is that it's easier to spend money than to let an industry compete with other industries that have strong voices. But that's the issue that we're facing.

The CHAIRMAN. Plus the fact that if we do not allow them to compete equitably with all the new boys on the block, then there will be a great clamor for rules and regulations to be applied to Merrill Lynch and Sears and everybody else, which—I do not favor that approach at all, trying to limit their activities. But there will be great pressure, in my opinion, for going that route.

Vice Chairman Martin, a lot of people may not know you have a unique experience now being a member of the Federal Reserve Board, but formerly occupying Dick Pratt's position as Chairman of the Federal Home Loan Bank Board. So, you've had unique experience with the thrifts.

What is your view of the argument that thrifts are not the cause of their present problems and therefore they should all be provided with capital maintenance instead of capital assistance?

Mr. MARTIN. Mr. Chairman, I would agree with the comments and those made by Chairman Pratt. I feel that there is a need to equip the regulators with a structure—a tool kit, if you will—to solve problems in the short run. But I believe we must at the same time, focus on the financial structure of tomorrow with those interim provisions of your bills—including S. 1720—which would put disciplinary pressure on management. Therefore, I believe that the blanketing of a whole industry under some kind of net worth threshold or minimum would be unwise.

The CHAIRMAN. Would you agree that if we just blanket the guarantee to these institutions, all of them will be maintained?

It would seem to me that there's a good case for doing the same thing for automobiles. Senator Riegle has a particularly different problem in his State with the automobile industry. It seems to me then that automobile dealers could stake at least some claim and say, "Why not us? Why not take a trip across the street? My automobile dealership is going down." I feel we'd set a very bad precedent if we just had a blanket guarantee, rather than trying to assist or help those to help themselves through good management to get through this transitory period.

Mr. MARTIN. I would certainly agree.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I wanted to ask a somewhat different kind of policy question at the outset. And I've got lots of specific technical questions that I want to get into.

FLOW OF MORTGAGE MONEY

But let me start with you, Chairman Pratt. Have you done an analysis—or can you give me your best professional judgment as to what is going to happen to housing in this country? I'm speaking now in terms of housing mortgages, have you tried, for example, to make a comparison between what is likely to flow in the way of mortgage money into home mortgages for families and individuals, say out over the next 5 years, under the kind of restructuring you're talking about versus what it might have been percentagewise in terms of available capital expenditures, say over the last 5 years or over the last 10 years?

Mr. PRATT. Those issues are fairly difficult.

Let me tell you what we have done. In the simulations that we have applied to the restructuring we've talked about, I believe we have looked at in the nature of 3 to 5 percent of assets being diverted into the new directions. So that would be about one-thirtieth to one-twentieth of the assets of the institutions. Whether that would be more or less than would occur without the restructuring is hard to say.

My personal opinion is that the restructuring would provide more mortgage credit because it's going to provide some additional profitable opportunities for these institutions. It's going to let them get back into the mainstream of competing for funds. And we're going to have a healthy, growing set of institutions which can provide funds, rather than a set of institutions which we have sort of legislated into an open-door liquidation and will be continually impaired in the future in their ability to provide mortgage credit.

The other thing which I see—and I think this committee, I am sure, is aware of, but should take careful note of—is that mortgages are going to be a profitable business, in my opinion, and there's going to be a good demand for housing and mortgages, albeit perhaps less than some people have estimated. But new technology is important there.

Looking at Merrill Lynch again, who is best suited in this country to tap the capital markets? Certainly a company of that type is well positioned. What have they done recently? They have purchased many real estate entities, real estate agencies. And what is going to happen—and it will happen, I think, very effectively—is that vertically integrated companies of this type will capture the sale at the time of the sale of the house, provide the mortgage financing, provide the mortgage-backed securities, and move mortgage credit into housing on a profitable basis.

I will be very surprised if we have a shortage of mortgage money under either scenario. It's really a question of giving this sector of the economy a right to survive.

HOUSING AFFORDABILITY

Senator RIEGLE. I hope you're right. I have a concern that you may be wrong, because it seems to me that what I'm observing is that less and less money is making its way into home mortgages and at higher and higher rates, opening up a gap.

When I talk to real estate people and I talk to individuals who are thinking of buying homes, if interest rates for long-term mortgages, or even rollover mortgages, get down in the range of maybe 12, 12½ percent, something in that area, people start thinking that maybe they can manage the carrying costs of financing a purchase. But there are other things at work that are causing people to slide backward in terms of their real income. So, home purchases are moving away from it and becoming more elusive.

What I'm concerned about is that I'm not sure we've made a basic policy decision as it relates to housing opportunities in this country. And then, without a clearcut decision, we've moved on to the question of how we want to deal with the thrift institutions which have been a driving force behind housing mortgages.

I don't know that the country yet has caught up with what is happening at the policy level. They just know that housing is becoming more and more difficult to achieve on a personal level. People are jammed into housing where they are now. They can't sell the house, they can't finance a new house.

And what I'm concerned about here is that unless you have a pretty well-defined notion as to how we're going to come out after a restructuring in terms of the percentage of available capital in this country that's going to be available for home mortgages at rates that people can afford, and not necessarily just in competitive market rates—if we're talking about ending up with a revised structure, where mortgage rates are in the range of 16 or 17 or 15 percent, or you're talking about a 3-year balloon-type situation with very high up-front costs, which you hope that somebody somehow can refinance down the line at a lower rate and that proves to be a false hope—that has happened to many people whose balloons are coming due now—you could find yourself having engineered a policy that fundamentally changes the pattern of housing opportunity in this country, which would be very much at odds with what the country wants.

And so, I am a little concerned. Everything I've heard you say today, and in other public statements, does not clarify what the policy foundation is, what the goal is that one is trying to achieve here as it relates to what has been the basic function of savings and loans, and that is to provide home mortgages.

And I'm concerned that you may not have clearly enough established your long-term goal and, from that, derived your ideas in terms of policy.

If I'm wrong, please correct me.

Mr. PRATT. Let me respond to that, Senator. Let's look at what the market and at what Congress has done. Public Law 96-221 and the market say that, in fact, institutions must openly compete for funds in the market. Regulation Q and differentials are going to be gone. That means everyone is buying the same dollar.

Now, let's assume that thrift institutions could operate on a zero markup. That would mean that they could make mortgage loans available at cost. It still is going to mean that mortgage loans are essentially at a market rate, and maintaining a limited legislative structure for thrift institutions will not in any fashion provide or solve the mortgage finance problem.

If the Congress believes that in fact mortgages should not be at market rates, then Congress must in fact subsidize home buyers. And I would suggest——

Senator RIEGLE. Let me just stop you there, because you can frame the question that way. Let me frame it differently and try to have you respond to this question.

I am saying that there has been a basic change in market structure which has had an almost catastrophic effect on the ability to buy a home mortgage for a vast number of people in this country. Most people today can't afford home mortgages because they are just too expensive. That is a new condition. It wasn't true 5 years ago. It is true today. And I am saying that if you just go ahead willy-nilly and lock in a new structure that keeps the problem as is without at least recognizing there are major policy implications in terms of a change in the availability of home mortgage loans to people. I think at a minimum you have a requirement to identify the problem.

Suppose, for example, the new condition that we're in, of which the problem of the thrift is just one measure of it, is that 35 percent of the American people are not going to be able to get home mortgages in the future. They could have gotten them 5 years ago. Let's say it is 50 percent. We are talking about that kind of a measurable shift.

If that is the case, or it is something in that range, isn't there a responsibility to identify that as a policy issue in terms of deciding what we want to do in managing our way out of this cash flow problem, out of this structural problem that exists within the thrift industry? And it seems to me that problem is being given the brushoff, that you are looking at this as a mechanical problem, and in part it is, a very important mechanical problem, to be adjusted.

But I don't see a sign that there is any real attention being paid to the fundamental change that is taking place with respect to what this means for housing opportunities across the country. I am not just raising it as an academic issue, because I think when the public catches up to what this means, if they find that we are locking ourselves into a new system where there has been a fundamental change in terms of access to home mortgages that people can afford, there is going to be a hell of an outcry from people in the country, saying, "Wait a minute, that is not what we want all of you to do."

That is not what we are interested in seeing happen, because that is a major policy change as it affects the quality of life for people in this country, and I am just concerned that you haven't really factored that in here. At least I haven't heard you say or offer anything yet that indicates that you have really nailed down that change in condition and are prepared to address that part of the problem.

Mr. PRATT. Let me try one more time. One, restructuring or failure to restructure has almost nothing to do with the issue you have talked about.

Senator RIEGLE. I understand that.

Mr. PRATT. If housing affordability is the issue, then there are two ways of dealing with that. One is through appropriate management of the economy, which gets interest rates down and makes capital goods such as housing affordable.

Now, I would be happy to offer suggestions, but this body hears tremendous suggestions and is dealing with that issue right now with regard to the budget. That is certainly Congress' responsibility and must be addressed.

The other option, if it is not considered the appropriate solution to get interest rates down and manage the economy correctly, then the other solution to make housing affordable is to subsidize it, to tax some people and buy other people houses. And we can administer that program. That is no problem if that is your will.

Senator RIEGLE. I want to make one point, and let me ask you to provide something specific for the record so that we can try to establish the answer to the concern that I have. It seems to me that we may well be moving into an era where we are going to end up with one-stop shopping for financial services, of the sort that you described in your example a while ago. And to the extent that that happens, and we break down or leave behind the old structure of different aspects of the financial institutions industry having a particular character—somebody is in the securities business; somebody else is in the housing business, et cetera—we break that down, we break down the geographic isolation or the State and area jurisdictions and so forth, you could end up with a situation where you have absolute free flow of money between institutions that all have the same character.

One of the problems when you have had a windfall change in interest rates anyway is that you may find that there is almost no money for housing mortgages. Yes, for very wealthy people or for people who are way out at one end of the income scale, but almost none left for anybody else, because that just becomes something that in a free marketplace of that sort is just something where capital won't go. And I am saying if we are into that kind of condition, I think you have some obligation to address that fundamental policy question.

You may not even want to put a value judgment on it, but, at a minimum, I think you have a right and a responsibility to do that. So, let me ask you for this specifically. I would be interested in knowing what you think.

First of all, I would like you to take the savings and loans, what is going to be left of the savings and loans in your proposal, say out over the next 5 years; what the total financial resources will be percentagewise in terms of the capital that is being allocated through all financial institutions and how much of that you see going into housing. Pick a base period, the last 5 years, the last 10 years.

In other words, what I would like to see you establish, as a minimum, is the degree to which the pool of money that is going to be lable, making its way into home mortgages, remains the same

percentagewise, increases substantially, or decreases substantially. And I think we have to understand what the policy relationship is to the end product in this case which I am interested in here, and that is home mortgages.

Mr. PRATT. We will be happy to do that. Our preliminary estimates indicate the restructuring would provide more funds, but I will provide a detailed—as much detail as we can for the record.

[See page 216.]

Senator RIEGLE. I would hope that would include projected average mortgage rates. [Laughter.]

I think that is important because if you are just making the assumption that we have got rates at 16 percent, that people can automatically afford mortgages at that level. Obviously, that is not workable.

The CHAIRMAN. I would like to know that, too. [Laughter.]

Senator RIEGLE. You obviously have to be making some forecasts here, because we are talking about locking in policy that is going to have a good effect for people out into the future. You are going to have to have some estimates. That is what you are paid to do.

Mr. PRATT. We understand that, and, of course, the affordability of mortgages is a function of what is done in getting inflation and interest rates down and not a function of restructuring.

Senator RIEGLE. Well, you have got to make some assumptions. So, would you take a look at that?

Mr. PRATT. We would be happy to.

The CHAIRMAN. I don't mean to minimize the Senator's request here, but rather than talking about estimates of what you think it will be, I assume you are talking about assumptions.

Senator RIEGLE. Absolutely.

The CHAIRMAN. Let me just make one comment before I turn to Senator Schmitt on this subject. I do feel very strongly, Senator Riegle, that there are, and I have looked at this issue for 1 year, two separate issues.

We in this committee can't do anything about the affordability. The whole Congress can, but this committee cannot. In looking at restructuring, that question has come up many, many times. I think the evidence is rather clear without being able to put a specific number on it, and I will be interested in the projections as well, that there will be more available.

And, I think that comes from a logical conclusion, in that the current condition of the thrifts is so unprofitable. There are thrift institutions in my State that have not made any mortgage loans for 2½ years, but in their present structure they are supposed to make mortgage loans, but they simply cannot do so.

Generally across the country, it has been reduced so dramatically from thrifts that when I hear the argument, particularly by some realtors, we can't get them out of the mortgage lending business, I don't know what it would be. Maybe you have got 70 or 80 percent now, and it would drop under restructuring to 50 or 60 percent. I would suggest that 50 or 60 percent is a lot better than nothing.

We do have some direct testimony which Chairman Pratt may be able to draw from. There are some examples. The newest member of the Federal Home Loan Bank Board testified before this commit-

tee at his confirmation that this State savings and loan in Texas, does have commercial authority, he testified, which was rather unusual—we haven't had too many of those in the last couple of years—that his institution made money in 1981 and that 83 percent of their assets were still in mortgage loans.

So I am hopeful, Chairman Pratt, that you can respond to Senator Riegle's request and give us as many specifics as you can. I realize there is a lot of estimating assumptions that have to be made, but I think from a general standpoint the current conditions, from what I hear from thrifts day after day after day, we are simply not making any mortgage loans, although their structure says that they should be.

I can't imagine that we wouldn't have an increase. I couldn't quantify what that would be, but I can't imagine that we wouldn't have an increase from the thrifts if they are able to stay in business and be profitable.

I won't take any more time. I have taken too much of Senator Schmitt's time.

Senator SCHMITT. Thank you, Mr. Chairman.

Mr. Chairman, I have an excellent statement here, and I am sure that, had I been here to give it, it would have been considered outstanding. [Laughter.]

The CHAIRMAN. I will ask that it be included in the record by unanimous consent as outstanding.

[The complete statement follows as though read:]

STATEMENT OF SENATOR SCHMITT

Senator SCHMITT. Mr. Chairman, today's hearing is a most unfortunate occasion for this committee and for the Senate. We are beginning to create something of a tradition in this institution with the Lockheed loan guarantees, loan guarantees to the Chrysler Corp., the loans to New York City, and now, mortgage assistance for housing, the most dramatic and some might say the most radical of these, Federal bailout programs for the S. & L. industry.

I do not say this out of disrespect for the legislation in question and I deeply appreciate the motives behind the sponsors of this bill. That it will pass is almost inevitable and I intend to support some form of legislation along these lines. But while we consider the form that this legislation is to take, I hope that we will keep in mind the radical nature of a proposal which provides for the Federal Government to underwrite the losses of the private institutions and, in effect, to potentially take an equity position in virtually hundreds and hundreds of private financial institutions.

Where this will end, if interest rates do not decline in the coming months, is anyone's guess. It is not at all extreme to suggest that a federally owned and operated savings and loan network is one remotely possible outcome.

I would like to comment briefly, Mr. Chairman, on the contention that it is the Federal Government that is entirely responsible for the creation of the problems facing the S. & L. industry. The fact of the matter is, it is only roughly one-quarter of the S. & L. industry which is currently facing a potential net worth problem. There continue to be a great number of excellently run savings and

loan institutions who have experienced relatively modest losses and who remain strong competitors in the marketplace.

I am very pleased that New Mexico has more than its fair share of strong and healthy savings and loan institutions. I would hope that one of the lessons learned by the S. & L. industry from what should be a rather humiliating experience—seeking net worth assistance from the Federal Government—would be the need for greater diversity in their activities so that they can avoid, to some extent, the solvent swings in profitability that accompany the cycling nature of the housing industry.

It is my feeling that the bulk of the blame for the problems besetting the thrift industry lies not at the feet of the Congress, but with the industry itself. To the extent that Federal regulation has imposed problems on the industry, those regulations should have been removed long ago and yet on many occasions we see that it is the thrift industry which is most opposed to the certainty of deregulatory moves.

Having said this, one must recognize that excessive Federal regulation, restrictions on operations, has played a role in bringing the current situation about. It would be my hope that, along with the enactment of S. 2531, the committee would look favorably upon efforts to remove the barriers which have prohibited the thrift industry from diversifying their portfolios and becoming more active in a wider variety of financial services.

The chairman deserves a great deal of credit for his effort to bring the many issues surrounding the deregulation of our financial institutions before this committee. While I do not support every provision of S. 1720, I feel that it does address these issues in a very formidable way and has promoted a great deal of productive discussion. I will look forward to participating in further consideration of the provisions in S. 1720 as we move toward action on the bill we are addressing today.

Finally, Mr. Chairman, I remain concerned about the continued existence of the infamous all-saver's program which was passed at the request of and with a vigorous lobbying effort by the thrift industry and the homebuilding industry last year. This program has failed to achieve any of its promised objectives, either as an incentive for the public to save more, or as a spur to increased housing. General incentives for savings and investment, such as provided for in the Schmitt-Packwood bill, S. 2214, are far more desirable than targeted credit allocations.

It would be my hope that with the passage of the pending legislation all efforts to continue the all-savers program would be abandoned by the thrift industry. This, I think, should be a necessary prerequisite to the Banking Committee's agreement to report this legislation.

The CHAIRMAN. By unanimous consent we will designate it outstanding. [Laughter.]

POTENTIAL FEDERAL LIABILITIES

Senator SCHMITT. Mr. Pratt, I think I will ask you to do this in spite of the great statistical effort that you have just been assigned

by the two Senators on my left. It is not often that Jake Garn is on my left, but, nevertheless, that assignment is an important one.

After you define and analyze your scenario—which I presume will assume various increasing and decreasing interest rates—could you also give the committee an estimate of what you would believe to be the resulting potential Federal liabilities under S. 2531?

We must also consider the effects of this program if the economy were to let the S. & L.'s get well. Now, according to our little accounting exercise, do you agree that those liabilities would not be called in and would eventually disappear?

Mr. PRATT. Some of those. That will certainly occur to a certain extent, and the more the economy improves relative to thrift institutions, the more that will occur, but especially without restructuring. This is real money you are spending, and a good deal of these will have to be paid off.

Senator SCHMITT. Are you saying that the S. & L.'s will fail anyway and will have to pay off?

Mr. PRATT. Yes, sir, especially without legislative action to bring about restructuring. This industry is on a course to oblivion, in my opinion. There will be a portion of the industry which survives, but it is simply legislatively misstructured for long-term survival, and this is going to be real money at some time in the future.

Senator SCHMITT. Then does S. 2531 represent real money?

Mr. PRATT. Yes, sir.

Senator SCHMITT. Is that over and above the losses as a result of deposit insurance?

Mr. PRATT. That is correct. That is over and above the amount we have to spend for institutions which become insolvent in any case.

Senator SCHMITT. Then I think it is even more important that we have the benefit of your estimates, again with varying scenarios. I don't expect you to use a crystal ball, but estimates on what the Federal liabilities would be under this, and relate them to the alternative in some cases, and that is of paying off the deposit insurance.

Mr. PRATT. All right.

[See page 216.]

Senator SCHMITT. And I would ask both Mr. Martin and Mr. Pratt some questions. In light of the extraordinary nature of the proposal, don't we need to sunset it? Need this be permanent? Shouldn't the Congress have to revisit this every year to make sure that it really believes we need to continue to do this?

SUNSET PROVISION

Mr. PRATT. I believe sunsetting makes a lot of sense in this particular issue. I think that perhaps a 2-year period originally would be more appropriate, given the amount of time that will go into setting it up and so on. But, again, the Congress needs to monitor what is happening to this industry. Is money being effectively used, or are we creating a new set of welfare recipients? And I think that that is a terribly important issue, that this kind of program should be reevaluated periodically and, as I have also stated, should certainly be tied to real answers to the problem.

Senator SCHMITT. Mr. Martin?

Mr. MARTIN. I would say, Senator, that with this legislation both the FDIC and FSLIC would be entering terra incognita in large degree.

Senator SCHMITT. Is that Latin for "wilderness"? [Laughter.]

Mr. MARTIN. Yes, sir.

Senator SCHMITT. We will lose jurisdiction?

Mr. MARTIN. I think we are trying some measures here that are quite new for all of us. We do not know what the market reactions will be to capital infusion and to the new kinds of supervisory actions. We do not know what management's reaction will be, as Chairman Garn has already indicated, and I think it would be vital to have a sunset provision.

I would support Chairman Pratt's suggestion that the sunset period should be longer than 1 year, because I think the set of reactions to whatever Congress does here is terribly complicated and we need 2 years or even 3 years to evaluate the effects of such legislation.

Senator SCHMITT. Mr. Isaac, do you have an opinion on that? Also, you may want to express an opinion now or for the record concerning the cost of paying off insurance with various options, various scenarios.

Mr. ISAAC. Well, on the sunset, if we are talking about S. 2531, I think it ought to be sunsetted.

Senator SCHMITT. Two years?

Mr. ISAAC. A 2-year sunset date would be fine. If we are talking about the regulator's bill and S. 1720, then, obviously, there is no place for a sunset.

Senator SCHMITT. I guess you all feel that S. 2531 standing by itself, doesn't really solve anything. But if you are going to buy time, he needs to give you some tools—is that the expression you used?

Mr. MARTIN. Yes, sir.

Senator SCHMITT. By which the management of S. & L.'s can get well again under the umbrella of S. 2531.

Mr. ISAAC. As far as the cost goes, if we were to implement S. 2531 in accordance with its terms, except that we would not allow the surplus ratio in an institution to drop below 1, and if you assume a 6-month T-bill rate of 12½ percent through 1984, this program would cost approximately about $2 billion by the end of 1984.

Senator SCHMITT. Is that cost or liability?

Mr. ISAAC. That would be the amount of the certificates outstanding at the end of 1984.

Senator SCHMITT. So at that point it would be an unfunded liability of at least that amount in that estimate?

Mr. ISAAC. It is funded in the sense that there are FDIC funds which would be available to take care of it if we had to do so. That is not a cost on top of the deposit insurance cost, however. In other words, if an institution should later fail, we would not have added anything to our cost by implementing this program, unless the institution's management does something in the meantime to worsen its condition beyond what it would have been had we not implemented the program.

We are going to have to spend a certain amount of money to resolve problems in the mutual savings bank industry, and we can spend that money today or we can spend that money 3 years from now.

Senator SCHMITT. It is different than the insurance programs. So are you saying that if you have one, you won't have to pay the other. Is that why it is not an added cost?

Mr. ISAAC. I am saying that to the extent that these institutions continue to operate in a high-interest-rate environment they will continue to lose money. This program simply papers over those losses and permits the institutions to continue to operate without giving them any meaningful assistance. There is little or no cash being outlayed.

If the institutions continue to lose money, we are going to eventually have to deal with them in another way. This program is not going to be enough. And when we deal with them, then we are going to lay out the money. So, we can either spend money today by doing a merger today, or we can spend it 3 or 4 years from now by doing a merger.

This program will not increase the ultimate costs unless the institution is mismanaged in the interim. The ultimate costs will be determined by the course of future interest rates.

Senator SCHMITT. You might want to provide a further explanation of that for the record. I think it would be very helpful. I think I see what you're saying, but it would be helpful to have another explanation.

[See page 546.]

Mr. ISAAC. Another way of saying it, perhaps, is that S. 2531 does nothing to solve the problems of the thrift industry. [Laughter.]

Senator SCHMITT. Are you saying it's not an added cost or potential added liability?

Mr. ISAAC. No, because we are facing exposure in the mutual savings banks that is almost entirely dependent upon what happens to interest rates. This program does nothing to change the underlying problem, and that's why I couldn't agree more with Chairman Pratt when he says that there has to be substantial restructuring of the thrift industry.

The CHAIRMAN. Will the Senator yield, so that the press doesn't only report Chairman Isaac as saying that this does nothing for the thrifts? I think it needs to be in the context that it has some short-time help, how we do some of these other things, and pray that interest rates go down. Just to leave it hanging out there cold that it does nothing for them, I don't think any of us would be for it if it did absolutely nothing. I understand what you're saying, but I saw the pens start to write instantly. [Laughter.]

Mr. ISAAC. If you would like me to clarify that more, the program does buy time, for the asset powers to come into effect. But the thrifts are losing a certain amount of money and they are going to continue to lose it depending on what happens to interest rates. This program is not infusing them with money, and even if it were, that would be simply a down payment toward the ultimate resolution of the problem.

Senator SCHMITT. It's not infusing them with money, but it represents a potential future liability.

Mr. ISAAC. We have that liability right now, by virtue of the fact that we have a deposit insurance system, and by virtue of the fact that these institutions are losing money. This does not increase our exposure.

Senator SCHMITT. This would not increase your exposure?

Mr. ISAAC. Not in my view.

Senator SCHMITT. It seems to me as though it's a different piece of paper, and therefore it's additive. But I'll have to read your explanation.

Mr. ISAAC. We'll try to do that in writing.

Senator SCHMITT. Mr. Conover, did you have any final comments on that question?

Mr. CONOVER. No. I think the $2 billion number that Chairman Isaac mentioned relates to the mutual savings banks, or at least far and away the bulk of it does. Looking at national banks, there are none that would qualify for assistance under this program today.

Senator SCHMITT. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon?

CRITERIA FOR QUALIFICATION

Senator DIXON. Mr. Pratt, in connection with S. 2531 there are certain criteria for qualification, the first two being that the institution must have a net worth of 3 percent or less, and have incurred losses during the two previous quarters. I believe my information is that in my State that would constitute about 85 percent of the thrifts. Would that be true, generally, in the country? Would the figure be that high?

Mr. PRATT. No, that would not be true, generally. The number—I'll have to supply for the record the number of 3 percent or less. It would be under 500, I think, at this moment, at 2 percent or less, but that number is increasing rapidly. There are market areas which are under more stress than others, and the area that you represent would certainly be one of those.

[See page 216.]

Senator DIXON. I see. Roughly what would the percentage be in the country? Is it possible that the percentage is as high as I have indicated in my State, or am I in error on that basic figure?

Mr. PRATT. It would be possible that that would be correct in the Chicago area, for example.

Senator DIXON. Now, S. 2531 says that the form and nature of the capital instruments and the form of consideration given for incorporation of the instruments are to be defined by the FDIC and the FSLIC with respect to the institutions. And following up on the questions by Senator Schmitt, could you, in a very simple, straightforward way, suggest how this will be done with those institutions who otherwise conform to the two things I've already suggested plus the other things that are set forth here that are mostly within the agreements between the institution and the corporation?

Mr. PRATT. This is the mechanical nature of the program.

Senator DIXON. The mechanical nature of the program.

Mr. PRATT. We have some experience in this and we have a number of institutions for which we have provided capital instruments. The instrument which the institution sells to the FSLIC or

provides to the FSLIC is called an income capital certificate and it would be somewhat similar to a subordinated debenture or preferred stock, which might be sold by an ordinary corporation, and it has some aspects of both debt and equity but it calls for repurchase of this under a circumstance of return to profitability.

Now, the FSLIC pays for the receipt of that instrument by issuing a promissory note which is a market-type instrument which is an agreement by the FSLIC to pay however much money we're talking about here, and to pay interest on it at essentially a market rate. For institutions which are at the point of insolvency there are strong supervisory actions which are associated with this. For institutions which would be participating in a broad national assistance program, abnormal supervisory oversight wouldn't be expected on our part, so it would simply be an exchange of instruments.

Senator DIXON. Well, in oversimplification again of the line that Senator Schmitt was following, I take it if the rates go down and the economy improves, we will win, because a lot of these institutions so fortified by this exchange will prosper and everything's going to be fine. If the scenario for the future is a bad one, if rates don't correspond to the things we do here and the policies of the Fed and those other things that are implicit in what ultimately results in interest rates in this country, and the economy doesn't improve, then we're going to have a problem here with respect to costs. Is that substantially correct?

Mr. PRATT. That's correct. We can look at thrift institutions as being in three categories. The first category includes those that are so well positioned and so well managed that they will survive regardless of what happens in the economy under any reasonable circumstances.

Senator DIXON. We're probably not going to be helping them with this anyway.

Mr. PRATT. That's right. The second category includes those that are in such bad shape or have such management problems or are in such a disadvantaged market that under almost any circumstances there is no way to make them viable.

Senator DIXON. And we're going to have to pay them ányhow.

Mr. PRATT. That's right. They will have to be paid in any case. There is a third group which has the raw material to succeed—and the size of that group depends again, on whether we restructure or not a group with the raw material both managerially and in a market sense, to succeed, and the two factors that will determine how many of them succeed are the interest rate change and the legislative flexibility.

Senator DIXON. That's exactly what I wanted to develop. And as to those, this bill is in fact very important because there are a great number of them out there, the ones who would not survive anyway and the ones who will not go down anyway, who may in fact survive by virtue of this mechanism; is that not true?

Mr. PRATT. That's correct.

Senator DIXON. Is that not the opinion of all of you?

Mr. PRATT. Without putting words into Bill Isaac's mouth, if I might sort of follow on what he said, if interest rates stay at a high level and if no restructuring occurs, the eventual liability is pretty

well known now. But there is a good chance that, in fact, interest rates will change and we have great hope that Congress will see its way fit to do some restructuring and give some additional flexibility.

If those things occur, the real costs can be lowered because institutions which would otherwise fail will, in fact, turn the corner and return to profitability and these instruments will be paid off and the cost that appears to be there now will never, in fact, occur.

Senator DIXON. One more question of you, Mr. Pratt. Then I'd like to ask one of Mr. Martin.

In view of all of that, do you think it's an appropriate condition of receiving this capital assistance that institutions agree to merge or change management if the appropriate regulator believes such a change is necessary? That is to say, should not there be more of a type of administrative hearing involved in that than a simple acquiescence by the institution, given the fact that most of them we're trying to save here are saveable, given the right kind of economic response in the next couple of years?

Mr. PRATT. Well, I think that's an important point. We think, of course, as regulators, and wearing the hat from this side of the table, that we act judiciously.

Senator DIXON. If I may interrupt, I don't want to belabor this too heavily, but I think everyone here, the Chair, everyone at that table has said that for the vast majority of these institutions, it isn't mismanagement or gross practices at the institution; it's the high interest rates and it's the economy that's destroying them now. So I put it to you, given the fact that we've all conceded some are going to fail, given the fact we've all conceded some are going to succeed, for those in the middle, who generally have had decent management practices but are suffering from the state of the economy, why should we put this requirement as a further burden on them?

Mr. PRATT. We would be comfortable living under a regimen where we ask for no merger resolution unless the institution were less than one-half percent net worth and within 6 months of failure. These are institutions that will fail.

NORMAL MONEY AND CAPITAL MARKETS

Senator DIXON. Mr. Martin, you did an interesting thing, I thought. In connection with the text of your prepared statement, you added some terminology I am curious about. You said the bill provides desirable discretion to the agencies to assure that assistance is provided only to those institutions that have reasonable prospects for viability at lower interest rates. Now, there was a period there when you added to your remarks, the record will show, in normal markets. I took note of that.

Now, what do you perceive as normal markets for interest rates as we deal with this problem, a problem that we've had? I'm a freshman member, but in the time I've been here since January of last year we've dealt with these kinds of markets. As well all know, there were some cyclical experiences involved. The market has been lower, it's been higher. But basically we are talking about long-term rates here that are fairly depressive to the economy gen-

erally. I would inquire, what do you view as normal markets in the addition of that phrase to your testimony?

Mr. MARTIN. My reference here was to normal real estate markets. However, I will answer the question which refers to normal money and capital markets. I think periods in which markets have been normal in our recent history have been rather transitory but one could characterize as normal those periods in which there is credibility in money and capital markets for both policy makers in the fiscal policy area and policy makers in the monetary policy area.

I believe the markets will return to normal when investment managers of the great institutions of the country feel that indeed the Congress will act responsibly and that deficits will be brought down over time; that the Board of Governors of the Federal Reserve System will continue to act responsibly and bring down the growth in the money supply to rates consistent with price stability; and that indeed, the result will be inflation coming down and staying down for extended periods of time.

Senator DIXON. And do you see the hope for those normal markets soon if we go ahead with some of the programs we're discussing here?

Mr. MARTIN. I follow with great interest the current deliberations of the House with regard to the various alternative budgets it is considering, as I did when the Senate was considering budgets for the coming year.

Senator DIXON. Did the budget of the Senate encourage you that there'll be normal markets soon?

Mr. MARTIN. I think it may be inappropriate for a member of the Federal Reserve Board to comment on the actions of the Senate regarding the budget.

Senator DIXON. I thank the Chair.

The CHAIRMAN. Senator D'Amato?

Senator D'AMATO. Mr. Chairman, I have a short opening statement that I'd ask be received into the record.

[The complete statement follows as though read:]

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman. Today we are attempting to find a solution to the urgent problem confronting our Nation's thrift industry. An industry that is caught in a vicious cycle spurred by high interest rates and low return on investments.

These institutions have served America's housing needs for the past 50 years. Since the Homeowner's Loan Act passed during the last Great Depression, no other lending institutions have helped fufill the American dream of homeownership the way the thrift industry has. To turn our back on this industry in their time of need would be a break with a commitment that we made to them, their depositors, their shareholders, and all Americans who dream of owning their own home. We cannot deny future generations the joy of being able to own land and the roof over their head.

Throughout the country savings institutions have lost $6.5 billion in 1981. First quarter losses are worse this year than the first quarter of last year. Savings and loans are failing at the rate of one per

day. The merger figures are frightening—approximately 160 banks and savings and loan's were merged last year. Brookings Institute projects that 1,000 savings and loan's will merger over the next 2 years. If interest rates do not abate, these figures will surely be conservative.

In New York City—one savings bank eroded 150 years of net worth in only 2 years. To say that this situation is intolerable is to minimize the damage. I am hopeful that these witnesses appearing before this committee will help us understand and come to grips with this serious problem.

Senator D'AMATO. I won't comment as to whether or not it's outstanding. [Laughter.]

The CHAIRMAN. We can try for unanimous consent. [Laughter.]

Senator RIEGLE. Reserving the right to object.

Senator D'AMATO. Then I would feel my colleagues would have to listen to me.

I am wondering, Chairman Isaac, if really S. 2531 is more than just something that well it's buying time, that it's really absolutely essential, totally essential, and let me touch on the reason why I see it as totally essential, not only to the thrift industry but really to the entire economic system, and we'd better admit it and be forthright, I think. I'm not going to create a panic. Maybe we don't like to talk about it, but I remember when there were certain people saying, "Let a few of the thrifts close their doors. Improper management, that's what it is; and the strong will survive and you know, the weak will fall, and that's the free enterprise system." I won't mention who said that, but that was the general attitude, and by the way, that attitude came out of a number of agencies and Treasury at an incredible, incredible level.

Then there was also a certain prejudice toward New York. It was a New York problem, you know. Let them pay the price; and how quickly attitudes begin to change, and it's unfortunate it took so long, but I think it's absolutely essential that S. 2531 come into being. Because if you were to value the thrift industry's assets and compare this figure to their market value, and assuming we close them all down, close all your inefficient ones let me ask you, does the FDIC and the Bank Board have enough to cover the liability, the exposure that's there? And what is that liability? I'd like an estimate. I think you'd probably have to give some kind of estimate. How many billions of dollars is there in terms of the difference between what they carry the assets for and what the market value is in the thrift industry?

Mr. ISAAC. That number is a large number but it's not relevant, Senator, because the transactions that we have consumated have cost us substantially less than that. Since last November we have handled nine assisted mergers involving assets of approximately $14 billion. The gross cost to the insurance fund is estimated over a period of many years to total about $1.7 billion. After the assessment credit is taken into account, our net cost is only 40 percent of that amount.

The short answer to your question is that this bill is not necessary, in our judgment.

BUILDING A BIGGER BALLOON

Senator D'AMATO. Not. I had a feeling that that's what you really believed. Everybody else, you know, kind of covers it up, but you really believe that S. 2531 isn't essential and you would continue this process of merging them, et cetera, and you don't see that you're just building a bigger and bigger balloon.

Mr. ISAAC. No. S. 2531 is not essential, in our judgment. We have no objection to it, as long as it gives us the flexibility to make decisions. Our first choice would be to continue to do mergers. If we can do a solid merger at a reasonable cost, we believe that is the cost-effective way to handle a problem. It is in the public interest and it's in the interest of the savings bank industry. If we can't do a cost-effective merger, then we would turn to capital infusion and we believe that the regulators' bill gives us all the flexibility we need to make those capital infusions.

In any event, we have an adequate fund to handle any contingency that we foresee in the savings bank industry. S. 2531 doesn't give us any money, in any event.

Senator D'AMATO. What is the potential liability? Let's get to the bottom of this. I don't want to hear you've merged out as a matter of record. Let's talk about the potential liability. Would you say that it's at least $50 billion?

Mr. ISAAC. No, I wouldn't, Senator.

Senator D'AMATO. You're saying to me that the market value, as compared to what the thrift industry is carrying on the books today, is not at least $50 billion?

Mr. ISAAC. That's not my estimate of what our potential exposure is.

Senator D'AMATO. I'm asking you what is the difference between the market value and what the assets are carried for.

Mr. ISAAC. I would say roughly 25 percent of the assets of the industry would be a good number to use as a current guide.

Senator D'AMATO. What would that give you?

Mr. ISAAC. I think we're somewhere in the neighborhood of $200 billion in assets, so probably $50 billion is a good number.

Senator D'AMATO. Well, if we closed the doors on these institutions, wouldn't we have a $50 billion loss?

Mr. ISAAC. We have no intention of closing the doors on these institutions.

Senator D'AMATO. Then we have to keep them afloat, don't we?

Mr. ISAAC. Or merge them.

MERGERS LOSING MONEY

Senator D'AMATO. And háve you shown any mergers that are making money, or are they still losing? You may have cut the rate of loss, but they're still losing, aren't they?

Mr. ISAAC. We have provided roughly break-even assistance in the merger transactions, so that no acquiring institution is losing money on any transactions entered into with the FDIC.

Senator D'AMATO. The banks that are operating that you've merged are still losing money, aren't they?

Mr. ISAAC. Some of those institutions were losing money before the merger. They're continuing to lose money after the merger.

They are not losing money on the assets that were acquired. Other institutions were profitable before the acquisition and they continue to be profitable. For example, we sold one institution in Spokane, Wash., to First Interstate, one of the largest multibank holding companies in the Nation. That institution was making considerable money before the transaction. It is still making considerable money now. The assets in the institution that was merged out were approximatly $700 million. Our estimate of the depreciation in the asset portfolio was somewhere in the neighborhood of $200 million, but the merger was consummated at a cost to the FDIC of $47 million. This amount was paid out by the FDIC in one lump sum, and the problem is gone. The assets now reside in First Interstate and they're never going to come back at us.

So that's why I take issue with the notion that our exposure is $50 billion. Our exposure is substantially less than that.

Senator D'Amato. Well, I tend to think that there are those who for whatever reason don't want to acknowledge what is a very real exposure that could take the whole system down, and that's why we need S. 2531 to buy that time, so they're not forced to close out. And it's going to cost better than $50 billion and your own assets, if we had the value of them, would be substantially less than what you carry them for at the present time.

But you know, let's get to something else, the regulators' bill. Let me ask Mr. Pratt. Chairman Pratt, are you satisfied with the regulators' bill as it pertains to the indemnification provision, because I'm not.

Mr. Pratt. Yes, we have no difficulty with it. My understanding of it at this point is that it doesn't provide for indemnification. It would provide for Federal mutual savings banks which would remain insured by the FDIC and yet be chartered by the Federal Home Loan Bank Board. From a regulatory perspective, we have no difficulty with that. It doesn't cause us a problem. We understand that isn't as responsive to the mutual savings bank, as they might like it to be.

Senator D'Amato. Do you think they have a legitimate cause for concern?

Mr. Pratt. I don't know. I don't have a basis on which to judge that. I suppose, to the extent that they view themselves as having most in common with the savings and loans and, in fact, we have a thrift industry in this country, that they have a legitimate interest in being more closely alined with the regulatory and credit facilities of that major segment of the thrift industry.

Senator D'Amato. They don't see themselves as being merged out as quickly, because there's a difference in philosophy. Would you say there's a difference in philosophy?

Mr. Pratt. Well, I don't know if it's a difference in philosophy, but we have, we believe, a much larger problem with much less resources and, therefore, we have to take approaches which, had we a different balance between resources and problems, we might not take. I don't know if it's philosophy. It may be behavior.

INTERINDUSTRY MERGERS

Senator D'AMATO. What is your thought about voluntary interindustry mergers as a means of obtaining operating efficiencies as well as a method of getting much of the needed private capital into the thrift industry?

Mr. PRATT. My personal opinion is that we are moving toward a substantial homogenization. I don't see any reasons to prohibit interindustry mergers. We are ready to see them. We certainly invite them in terms of solving the problems. We would like to have them as a solution to the problems. We have had some of these in the past, and they have really worked very well. The National Steel example, I believe, coming in with Citizens and taking two of the major problems in this country, is a rather good indication of what can be done.

Senator D'AMATO. It seems to me that under the Bank Holding Act of 1970 we had the ability to approve interindustry mergers. By including the word "emergency" are we prohibiting that kind of transaction in the future? Why would we want to say only in terms of an emergency? Isn't that a diminution of flexibility?

Mr. PRATT. I believe the reason for considering that at this time is to allow Congress to take the small step possible in changing financial markets, while at the same time providing some real solutions. We as a regulatory agency would have no problem with Congress being more aggressive; however, we would like to use that interindustry issue to solve some of the problems in the meantime.

Senator D'AMATO. I'm just afraid that word "emergency" could create some problems. I have some problems with it.

Mr. Martin, I'm wondering if you would comment on the situation in terms of the bank holding companies' purchase of thrifts, how you view that. Second, let me pose something to you. If the managers of a saving bank could, with the help of the capital assistance program and the new accounting techniques that are called for, restructure an institution to be viable in the long run, recognizing that everything is tied to the economy and interest rates are coming down, wouldn't this be preferable to forced mergers by the FDIC, in your opinion?

Mr. MARTIN. Senator, on your first question I believe that the regulators agree this seems to be the intent of Congress that the acquisition by a bank holding company of a thrift institution should be, in effect, the last resort in finding a solution for a problem institution or an insolvent institution. I hope this will be clarified by the consideration and passage of these two bills. First of all, an effort should be made to find a like institution within the State and second to find a similar-type institution outside the State. The third and fourth options should be acquisition by a different-type institution in the same State and in another State, respectively, I think an acquisition across industry and State lines, for example, a bank holding company acquiring a thrift, is a last resort, but I think it should take place if that is the only way to solve the problem. We at the Board of Governors seek your guidance as to how this should work, and one of the two bills does, indeed, contain such guidance.

Senator D'AMATO. Down with McFadden.

Mr. MARTIN. No comment. You referred to accounting techniques. I take it the Senator means purchase accounting?

Senator D'AMATO. What about S. 2531 and using the accounting techniques which the Bank Board allows? I'm saying, if you're able to do that, isn't that preferable then to just the forced mergers, in buying time, while hopefully, the economy improves, so we don't have the dramatic liabilities that may arise; because if the economy doesn't improve we're going to have that situation, and I certainly hope that Mr. Isaac's prediction is correct that the $50 billion exposure, this potential exposure doesn't come about, but it's there.

Mr. MARTIN. Our position on this is, of course, that the FDIC and the FSLIC are the supervisors that are out there in the trenches. They have to solve the problems. They have the most immediate experience. If either of those insuring agencies feels that accounting techniques suffice, I think in most cases we would support them.

Senator D'AMATO. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Pratt, we've heard complaints that the Bank Board is biased in favor of structuring the savings and loan industry by merger and that the bias runs to creating large units that cross State lines in violation of the spirit of McFadden. Remembering that Congress has not specifically permitted interstate branching for thrifts, I'm inclined to think that against that background, S. 2531 gives the Bank Board too much discretion, requiring as a condition to capital assistance, a resolution by the S. & L. authorizing the Bank Board to merge it out of existence.

What's your view?

Mr. PRATT. Well, first, let me say, we, of course, don't agree with the bias which you say exists or the perception of the bias which exists. Of the total mergers which were done last year, I believe 11 were interstate out of about 300. So that would be a relatively small percentage. Second, I think it needs to be very clearly addressed, and I think it's a bum rap, that the insurance agencies are restructuring the industry. The thing that is restructuring the industry is the high interest rates and the legislative limitations which have been on these institutions. The insurance corporations have the obligation to deal with failed financial institutions, and the only thing we deal with are failed financial institutions in that sense.

Now it may be that the world isn't fair and that these institutions shouldn't have failed, and that it was caused by interest rates and overly narrow legislative situations. That's a separate point. Second, in terms of S. 2531, we would not intend to force mergers or other solutions until an institution was at the point of failure. We have no desire to restructure this industry in terms of mergers or consolidation. We think, in fact, it's going to occur regardless of the legislative direction, simply because market changes have occurred, but we, in general, have not moved institutions to FSLIC mergers until they are virtually failed institutions.

Senator PROXMIRE. Well, I understand that, and I understand your feeling that you're being pushed into that because of the terrible problem that S. & L.'s have because of high interest rates. The

alternative, of course, is capital assistance to get them over this tough time, instead of merger with an out-of-State institution which does violate the law that we put on the books, and many people feel very strongly about, on interstate branching.

Mr. PRATT. I understand that feeling. We feel that, in general, the approach of trying to save every institution probably would very detrimental to the industry and to the public, and we don't support such an effort. We believe evolution has to take place. Institutions which, in fact, will survive and serve the public and provide more mortgage funds would be damaged under a holding pattern that seeksto keep all institutions alive. We should not use public money and the taxpayers' money to freeze this set of institutions.

Senator PROXMIRE. I would certainly agree that all institutions shouldn't be kept alive, but this is a terrible time, it seems to me, to test the viable institutions. You can have a very well-run, well-managed, conscientious institution which is in terrible trouble today. I think you'd agree, wouldn't you?

Mr. PRATT. We agree with that, and we fully support S. 2531 and the restructuring legislation which can return health to the institutions, but S. 2531 by itself only buys time. If evolution doesn't occur along with it, we're going to have a much worse problem in a couple of years than we have now, if interest rates stay up. If they come down, the problems will be mitigated in any case.

LIMITED CAPITAL ASSISTANCE

Senator PROXMIRE. Mr. Martin, let me ask you this. S. 2531 permits assistance to commercial banks. I'm concerned that large international banks may qualify for such assistance. Shouldn't capital assistance be limited to community-oriented institutions that are bearing the brunt of high interest rates while investing in home mortgage loans and small business and agriculture rather than big banks? Shouldn't we take big banks out of the act, since they, by and large, don't really, generically, at least, need this.

Mr. MARTIN. Senator, I certainly have spent most of my working life with smaller institutions, and I have great sympathy and empathy for the community-based institution. I am confident that the evolution of our financial system will leave strong community-oriented institutions, but I have trouble and discomfort with the Senator's suggestion, in that we have today a financial system that has never been so interdependent. We have today a financial system that has never been so much under the spotlight or scrutiny and that has never been given so much media attention. And I would be loath to see this committee or Congress act in such a way as to exclude certain institutions and include others. I would be fearful that any difficulties that might be encountered by institutions excluded would spill over into those very community-oriented institutions and the whole financial system.

Senator PROXMIRE. You want the discretion yourself, you want it in the law, that would exclude large institutions, even though it would seem to me that they, by and large, with the little experience I've had compared to yours, would suggest that the big banks are usually not in in a big way—home mortgages, for example.

They don't have that problem. I don't know any big bank that has more than a tiny percentage of their assets in home mortgages. I don't know any small bank that doesn't.

Mr. MARTIN. On average I would accept the Senator's facts, but there are likely to be exceptions.

Senator PROXMIRE. Then why should S. 2531, which is designed to meet this particular terribly serious problem for S. & L.'s and small banks, why should it be used for large international banks at all?

Mr. MARTIN. I would say because of the extreme interdependence here. I think the question of a large bank's role in the mortgage market is an important topic, but it is a different topic from the matter of liquidity.

Senator PROXMIRE. If a thrift is required by a bank holding company to cross State lines under S. 2532, shouldn't the thrift be required to comply with State branching laws, so that we do not repeal the McFadden Act in attempting to deal with thrifts that are in trouble?

Mr. MARTIN. Yes, I think that every regulator has the duty to restrict the acquired powers—branching and otherwise—of financial institutions in these situations.

Senator PROXMIRE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, I have a lot of additional questions, but we're 2 hours and 15 minutes, and still have two more panels and three more witnesses, so I will forego any more oral questions and submit the remainder of mine to you in writing.

Senator Proxmire has some for the record, and I assume there will be many additional questions from other members of the committee who were not able to be here for the hearing.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman, I'm only going to ask a few questions, and I also have some which I'm going to ask the panel to respond to for the record.

Let me ask you this, Mr. Pratt, or any of you, for that matter. If we take a look now at the depository institutions, the savings and loans, and the commercial banks and the other depository institutions, I would like to know what the current figures are as to those which have a net worth greater than 2 percent, less than or equal to 3 percent, and how many would fall in the 1 percent to 2 percent area, and how many would be between 0 and 1 percent. Where are we right now?

Mr. PRATT. I'm not sure that I can instantaneously put my figures on those numbers. I would prefer to supply that for the record.

[See page 216.]

Senator RIEGLE. Let's see what the staff has here. It's very important that we know where we are. It may be that others at the table would have that answer.

Mr. PRATT. As of the end of March, their lowest one-tenth of institutions, which would be about 370 institutions, had net worth to total assets of about 87 basis points. This would be just under 1 percent. The next 370 had 2.2 percent as a median for that category. Therefore, it would seem something in the neighborhood of 600, maybe 500 to 600, would be at 1 percent or less. The third one-tenth which would also be approximately 370 institutions, were at

a 2.99 percent net worth to assets ratio. So if we take the 3 percent or the first three deciles—which would be three-tenths of the industry or about 1,000 institutions, something of that nature, would be—it would generally be under 3 percent.

Senator RIEGLE. Do we have any now who are as low as zero?

Mr. PRATT. There would be a small number, a handful, who are awaiting an imminent solution.

"SOLE DISCRETION"

Senator RIEGLE. In S. 2581, the language of the bill says, and I quote—it is on page 2 of the bill—that the FSLIC "in its sole discretion and on such terms and conditions as it 'may provide' is authorized to increase and maintain the capital of a qualified institution."

I tried to remember in the 20 years that I have been in the Congress if I have seen language that is as permissive as that in terms of a blanket grant of authority to an agency, and I am hard pressed to recall one that is quite as sweeping as that. The question in my mind is whether it is good public policy to give any independent agency such sweeping authority.

I am just wondering why we wouldn't be better off having the Congress actually set the terms, obviously in discussion with you and with the recommendations that you all might make.

Why aren't we better off actually creating some standards here rather than to just "sole discretion" and "may provide"?

Mr. PRATT. Well, the language which is expressed there essentially exists now in 12 U.S.C. 1729(f) and has existed for many years. I would think Congress would probably actually prefer to have that discretion in the regulatory agency. This does not mean that an institution is arbitrarily terminated. If there is something that can be worked out, the regulator works it out with them. It just gives the regulator the flexibility to deal with the failed institutions or failing institutions at the least possible cost.

Putting restrictions on that ability I suspect would increase the number of institutions failing and would probably increase the cost.

Senator RIEGLE. We have never been in a time quite like this, have we?

Mr. PRATT. No, we have not, but I don't think that anyone can accuse the FSLIC of having squandered the public funds by having used them injudiciously, but it is an issue that certainly is in the hands of Congress.

Senator RIEGLE. My concern is that there is a kind of avalanche situation developing. You see it in the bankruptcies in nonfinancial insitutions. We are on an exponential curve right now in bankruptcies, and you may well find yourself in a situation where you are going to have so much to contend with in such a short space of time that you do it 24 hours of the day just like we do.

It just seems to me we might want to think about whether or not we need some kind of guideline or some kind of standard here against which to manage our way through crisis problems.

But you wanted to comment?

Mr. ISAAC. I think, Senator, you have to be very careful in the desire to create guidelines. First of all, we are dealing, particularly at the FDIC, with some very complicated situations involving major institutions. We must have discretion to decide what is the most appropriate way to resolve a particular problem.

Second, we must to be very careful, even in dealing with Chairman Pratt's situation, to avoid litigation. Chairman Pratt must have a fair amount of leeway so he can't be sued for the judgments he makes.

Finally, I would point out that this bill is not providing any public money to the insurance funds. The insurance funds are supported entirely by the banks and S&L's. No taxpayer money is involved. Therefore, there should not be a lot of strings tied to how these funds are used.

Mr. PRATT. Senator, if I might just follow up on a couple of examples? Without discretion it is possible that we could have had liquidations of multibillion dollar institutions in the State of New York and in the State of Illinois, for example. We have found it necessary in those cases to go in and provide capital support sufficient to maintain the operations of institutions, and if that were legislatively impossible, I think it could have had catastrophic effects.

Senator PROXMIRE. Senator, would you just yield for a second on this, because I think you have got a very good point. What bothers me, Mr. Isaac and Mr. Pratt, is on page 1, line 8 of S. 2531, it says, "Notwithstanding any other provision of State or Federal law and without limitation on any authority provided elsewhere in the act," and so on and so forth, "and in sole discretion of such terms and conditions as it may provide, the corporation is authorized to increase and maintain the capital of the qualified institution by making periodic purchases."

In other words, without limitation of any authority, State law, Federal law, whatever; you have absolute discretion. Doesn't that go too far?

Mr. PRATT. I think I have expressed the opinion that I don't think it does; that the general oversight which the Congress has of these agencies is sufficient to prevent abuse; and that of all the criticisms we have had, I don't know that anybody has criticized us for being overly liberal.

Senator PROXMIRE. You are not under any State authority, and here you can override state law by this passage in this bill.

Mr. PRATT. I understand that. We need that particular authority in order to insure that the benefits of the program will be lawfully available to State-chartered institutions in some States.

Senator PROXMIRE. Thank you.

Senator RIEGLE. I think this is a key issue, and it is one we are going to have to debate more fully because it is an extraordinary grant of power. Granted, we are in a crisis situation, but I think that is where the value of having some structure, some guidelines, some way of making sure that there is going to be equity from case to case is clear.

I mean, we can find ourselves in a situation here where you may very well find yourself tied up in litigation because you have a hard time being able to demonstrate why your treatment in one

situation might be markedly different than the treatment that occurs in another one, and just a short time later.

Let me ask you this: You have had some success in finding partners for S. & L.'s who failed to meet the net worth requirements over the last 18 months or so. Are you optimistic that you can continue to find willing partners for the hundreds more that are out there that are eroding their net worth and are heading into a situation where something has got to be done? Are you going to be able to make all these mergers?

Mr. PRATT. Well, the question of effecting mergers is, of course, a question of how much assistance is provided. At the right level of assistance there are numerous and unlimited merger partners.

We, of course, have tried to husband the FSLIC funds, and as conditions continue in a severe status, of course, we find that the number of solutions at the cost that we previously had tends to dry up. So, as economic conditions remain difficult for thrifts, the cost of solutions increases over time.

Senator RIEGLE. Well, I am very much concerned about the fact that I think we may be running out of our ability to do that. I just don't know how many more you can manage, especially if you are in an enlarging number of problem situations. I asked the question before in terms of how much residual net worth there is in the S. & L.'s. I would like to know that for the other institutions as well. So could you give me those figures for the record?

Mr. ISAAC. As for the mutual savings banks, there are only 3 percent of these institutions with less than 3 percent surplus. One percent of the mutual institutions have less than 2 percent surplus, and no institution has less than 1 percent surplus.

For commercial banks, I don't have those statistics before me, but I suspect that there are none below a couple of percent that we aren't monitoring very closely and with some kind of action contemplated. It would be a very small number of banks.

Mr. CONOVER. Senator, I can add to that for the national banking system there are no national banks that are below 3 percent. There are very few, less than a handful, below 4 percent. And the vast majority, in terms of numbers, are up in the 6, 7, 8, 9, even 10 percent range.

As I indicated earlier, there are no national banks that would qualify for assistance under this plan.

Senator RIEGLE. I have, Mr. Chairman, a number of other questions that I want to pursue with Chairman Pratt and the others, and I think in the interest of time I am going to ask that those be responded to for the record. I know you have other witnesses who are scheduled to appear.

So, let me have these questions submitted for the record, and I would ask that they be responded to fully by members of the panel.

[Additional material received for the record follows:]

VICE CHAIRMAN MARTIN'S RESPONSES TO WRITTEN QUESTIONS FROM SENATOR PROXMIRE

Question 1. Under S. 2531, an institution qualifies for capital note assistance if, among other matters, it has 20 percent of its assets in real estate mortgages. What about small business and agriculture? Many community banks may be in difficulty because of this type of investment. Shouldn't small business and agriculture qualify along side of home mortgage lending?

Answer. As I understand it, the underlying purpose of the proposed capital assistance legislation is to give transitional aid to financial institutions that have low-yielding, long-term, fixed-rate assets. The capital infusion is intended to permit them to absorb the pressure on their earnings until interest rates fall and their asset structure is brought into closer alignment with the composition of their liabilities. While I am greatly concerned about the plight of small businesses and farmers in the current financial environment, loans made to them generally do not have the characteristics of mortgages which have caused the problems of declining net worth for institutions with a relatively high proportion of their portfolio devoted to traditional types of mortgage loans. Also, banks that make a relatively high proportion of their loans to small business and agriculture tend to have much greater portfolio diversification than institutions that concentrate in mortgage lending and, as a result, have been faring relatively well in recent periods. Therefore, I do not think that small business and agricultural lending should qualify an institution for assistance under S. 2531.

Question 2. S. 2532 provides that in authorizing the acquisition of thrifts, even across state lines, the "paramount" consideration shall be to minimize financial assistance by the regulators. Doesn't this go too far? Out-of-state bidders might pay a premium just to operate interstate. Shouldn't the regulators set a reasonable price for an institution and give a right of first refusal to in-state partners?

Answer. One of the purposes of S. 2532 is to increase the flexibility of federal regulators in finding merger partners for troubled institutions without undermining the principles established by the McFadden Act or the Douglas Amendment. The bill seeks to accomplish this objective by requiring that federal regulators first make a reasonable effort to find a merger partner that is the same type of institution and located within the same state. If such a merger is not possible at a reasonable cost, then regulators may explore the possibility of a merger with a different type of institution or an interstate merger. I believe that these guidelines and limitations will provide federal regulators with the flexibility they need in handling distressed institutions and would not lead to a wholesale restructuring of our financial system.

FEDERAL DEPOSIT INSURANCE CORPORATION,
Washington, D.C., June 21, 1982.

Re S. 2531 and S. 2532.

Hon. JAKE GARN,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: We are pleased to respond to the additional questions you have submitted to us.

Question 1. S. 2531 requires institutions receiving assistance to agree to comply with all terms and conditions established by the Corporation, including resolutions to merge or reorganize. The bill that was passed by the House essentially prohibits conditioning assistance upon such a resolution.

(a) How important is such a provision and would you continue to support this bill it it was amended to preclude such resolutions? Explain.

(b) What is your view on including a standard that is similar to the provision that was added to the House bill which allows the corporations to require such a resolution only if the institution receiving assistance has new worth of less than ½%?

Answer 1(a). We believe it is quite important that the regulators have the authority to impose sanctions against management as a condition for receiving capital assistance. Under the House bill the assistance certificates represent a contingent liability for the U.S. Treasury. Under the Senate bill the contingent liability is against the respective deposit insurance funds. Either way the funds should be committed responsibly so that actual expenditures are kept to a minimum. Strict sanctions were authorized when Congress offered assistance to Lockheed, New York City, and Chrysler for this very reason and when we provide assistance under Sec. 13(c) of the FDI Act we impose conditions concerning operation of the institution. We believe this is a sound concept.

If you consider that of all the banks we supervise only about 250 are on our problem bank list it should be obvious that management practices and capabilities vary. Because we supervise both sound and unsound institutions we are able to make fair and reasonable judgments about wasteful management practices. It would be an unwise waste of public funds to perpetuate managers, practices or institutions which are destined to failure when the assistance terminates. As we interpret the House bill it only prohibits a request for merger authority as a prior condition to obtaining assistance. It leaves the regulators with authority to impose sanctions and to terminate assistance and merge the bank out of existence if it is determined the bank is failing despite the assistance. Without these authorities we would be strongly opposed to the bill.

1(b). We think the one-half percent figure or any other figure is inappropriate.

Question 2. S. 2531 authorizes the FDIC and FSLIC to provide capital assistance for any insured institution that meets the eligibility criteria set forth in the bill. Therefore, if a commercial bank meets the criteria, it is eligible for assistance.

(a) What are your views on including commercial banks if they meet the eligibility criteria? Do you believe that is appropriate, or should the legislation be limited to only thrift institutions?

(b) The House bill currently applies more lenient standards for commercial banks by qualifying them for assistance at higher net worth levels than the thrifts. Do you support or oppose that provision? Explain.

Answer 2(a). As indicated in our testimony, we do not believe the capital assistance provided for in S. 2531 or the House bill is very appropriate for the institutions we insure including commercial banks. Among the commercial banks we supervise we are not aware of any which would qualify being under the bill's criteria. Furthermore, it is important to note that problems being encountered by commercial banks are significantly different than those being encountered by thrifts. We would exclude commercial banks from the bill.

2(b). We cannot perceive any rationale for the provision allowing commercial banks to qualify for support at a higher level of capital. We oppose this provision.

Question 3. Chairman Pratt opposes including nonfederally insured institutions within the scope of any capital assistance legislation.

(a) What is your agency's position on including state insured institutions

(b) Describe the regulatory and supervisory complications, if any, that would be entailed by including state insured institutions within this capital assistance bill.

Answer 3(a). We are totally opposed to the proposition that state-insured institutions should be covered by the Capital Assistance program. Our opposition is considerably more resolute with respect to the Garn assistance plan since the Federal insuring agencies would be using their respective funds as resources for the program. There is no way that we can justify the expenditure of Federal deposit insurance funds to prop up state-insured banks who have not paid into and supported the insurance programs.

Massachusetts is the only state with a state insurance fund that insures mutual savings banks. A couple of years ago, the banking commissioner in that state sponsored legislation to disband the state insurance plan and transfer insurance responsibility for state-insured mutual savings banks to the FDIC. The FDIC cooperated to the fullest extent by agreeing to absorb all of these institutions—the weak and the strong—into it system without even requiring that the insurance funds accumulated by the state be turned over to the FDIC (a reasonable indemnity from the state plan would have been required for a limited period).

The proposed legislation was not adopted due to opposition from some state-insured institutions. Nevertheless, the FDIC has since accepted a number of applications from individual savings banks, and firms holding approximatley 50 percent of the assets in Massachusetts are now federally insured (no application has been denied by the FDIC).

Some months ago a delegation of state-insured mutuals from Massachusetts met with the Chairmen of the Federal Reserve and FDIC. They wanted assurance that our agencies would assist their state insurance plan should that become necessary. We did not grant the assurance.

We took the position that they could join the Federal insurance system at any time and subject themselves to Federal examination and regulation—incuding interest rate ceilings. They would also be required to begin paying insurance premiums to the FDIC.

We were informed by the delegation that our position was unacceptable because these banks did not wish to abide by Federal regulations, did not wish to be examined by a Federal agency and did not wish to pay Federal deposit insurance premiums. We responded that we admired their independence and spirit but could not

reconcile their position with their request for assistance from the very Federal agencies they had chosen to eschew Our attitude remains the same.

3(b). We believe any state-insured institution applying for assistance under this program should be subject to Federal rules, regulations and insurance premiums. If these institutions choose to remain outside the Federal system of insurance and oversight, they should not be eligible for Federal assistance, irrespective of any indemnification considerations that may be proposed. The individual states, consistent with the spirit of the "New Federalism", should deal with their problems as may be appropriate. Provision of a Federal bailout without any regulatory strings attached would be a great injustice to the vast majority of depository institutions which have financially supported the Federal system and abided by its rules.

Question 4. The House passed Capital Assistance Bill requires the insurance corporations to consult with the State supervisor of the State in which any state chartered institution is located with respect to the eligibility of such institutions.

What are your views on that provision?

Answer. We would have no objection to consulting with the appropriate State supervisor of a State-chartered bank in determining its eligibility for capital assistance. In fact, we would undertake such consultation even if not required by the statute so as to have available all relevant input in this regard However, final decisions regarding the provision of assistance must remain with the Federal insuring agency.

Question 5. S. 2532 requires the FDIC, in making decisions about "extraordinary acquisitions" of insured banks (Sec. 106), to consult the State bank supervisor of the State in which the bank which is closed or in danger of closing is chartered. The provision gives State supervisors at least 24 hours to object to the determination of FDIC, and if there is an objection, FDIC can proceed only by a unanimous vote of the Board.

Section 102 of S. 2523 permits the FDIC to require a savings bank to convert into a Federal stock savings bank if certain conditions exist (i.e. to prevent a closing or reopen a closed bank, etc.). What is your view on including a provision for State consultation similar to that which is contained in Sec. 106 with respect to "extraordinary acquisitions"?

Answer. We would have no objection to including in Section 102 of S. 2532 a State consultation requirement similar to the ones in Section 106.

Question 6. What is your view on adding a provision to S. 2531 which would require the FHLBB and the FDIC to promulgate regulations implementing the provisions of the Capital Assistance Act?

Answer. We do not believe that mandating the issuance of such regulations would serve any useful purpose. In fact, because of the lengthy process normally required by law for issuing regulation, adding such a provision to S. 2531 could very well result in undue delay in utilizing the authority contained in the bill.

Question 7. The National Association of Mutual Savings Banks has recommended that S. 2532 be amended to provide for full indemnification by the FDIC for savings banks switching to FSLIC insurance. What are you views on this suggestion?

Answer. We are unalterably opposed to this proposal and have stated on numerous occasions that if such a proposal is contained in the final bill we would recommend to the President that he veto it. Sections 102 through 105 of S. 2532 provide a mechanism for the conversion of mutual savings banks to Federal Charters which is fully supported by the FHLBB and the FDIC and resolves the indemnification problem to our satisfaction

Nevertheless, we met with the National Association of Mutual Savings Banks on June 14, 1982 in an effort to accommodate their remaining concerns. We are currently working on another proposal which we hope will finally resolve the question. Frankly, our patience is wearing somewhat thin on this issue.

Sincerely,

William M. Isaac,
Chairman.

Comptroller of the Currency,
Administrator of National Banks,
Washington, D.C., June 18, 1982.

Hon. Jake Garn,
Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C.

Dear Mr. Chairman. This is in response to your letter of June 11, 1982, that posed several questions concerning the proposed Capital Assistance Act of 1982. Our response are set forth below following each enumerated question.

Question 1. S. 2531 authorizes the FDIC and FSLIC to provide capital assistance for any insured institution that meets the eligibility criteria set forth in the bill. Therefore, if a commercial bank meets the criteria, it is eligible for assistance.

Answer (a) What are your views on including commercial banks if they meet the eligibility criteria? Do you believe that is appropriate, or should the legislation be limited to only thrift institutions?

(b) The House bill currently applies more lenient standards for commercial banks by qualifying them for assistance at higher net worth levels than the thrifts. Do you support or oppose that provision? Explain.

The commercial banking system, although essentially healthy, is not immune to problems of the present economic environment. It would be equitable, therefore, for banks to be eligible for assistance on the same basis as other institutions.

There is no justification or need for a more lenient standard with respect to banks. A more lenient standard would merely divert funds from needy institutions to help essentially sound banks. Therefore, we prefer the provisions of the Senate proposal which would apply the same eligibility criteria to all institutions.

With respect to national banks, no bank has a net worth below 3 percent of assets and very few fall below 4½ percent. Of those national banks having new worth below 4½ percent of assets, none would currently qualify for assistance under the provisions of S. 2531.

Question 2. Chairman Pratt opposes including nonfederally insured institutions within the scope of any capital assistance legislation.

Answer (a) What is your agency's position on including state insured institutions?

(b) Describe the regulatory and supervisory complications, if any, that would be entailed by including state insured institutions within this capital assistance bill.

We oppose including state insured institutions in the proposed federal capital assistance program. Those institutions have elected to avoid the expense and restrictions of federal insurance. We see no justification for why they should now be permitted to obtain extraordinary assistance, particularly if such assistance would involve federal insurance funds.

Federal assistance to state insured institutions would cause substantial confusion with respect to the supervision of assisted institutions. These institutions necessarily would be subjected to substantial federal scrutiny designed to minimize the risk to federal funds but would also remain under the supervision of their primary state supervisors. The inevitable confusion is yet another reason for OCC's opposition to this proposal.

Question 3. Chairman Isaac recommends deleting the provision in the capital assistance bill that would limit capital assistance to 100 percent of losses because he believes it is unduly restrictive and inhibits flexibility. What is your view on that recommendation?

Answer. I agree with Chairman Isaac's recommendation. The cap on possible assistance might be unduly restrictive in some situations. Since it is the FDIC's objective to ensure the continued viabilty of assisted institutions, maximum flexibility in assisting failing banks and thrifts is appropriate. However, I believe that the additional flexibility available by the deletion of this provision would be used sparingly. It should not be regarded by the FDIC as a license to provide unlimited assistance to failing institutions. Similarly, eligible institutions should not assume that such assistance by the FDIC would be readily forthcoming.

Question 4. The House passed Capital Assistance Bill requires the insurance corporations to consult with the state supervisor of the state in which any state chartered institution is located with respect to the eligibility of such institutions. What is your view on that provision?

Answer. We approve of such "state consultations" and would support a similar provision in the Senate bill with regard to federally insured state-chartered institutions. The state supervisors, as a result of their chartering and supervisory role with respect to state institutions, have experience and knowledge about these institutions and the marketplace in which they operate. Such expertise could indoubtedly assist the FDIC and the FSLIC in carrying out their responsibilities under the proposed Capital Assistance Act.

However, a state supervisor should not have the authority to veto a capital assistance plan proposed by a federal insurer. Under the Senate bill, resources of the FDIC or the FSLIC would be used to underwrite the assistance plans. If an assisted institution should fail, the applicable federal insurer would suffer the loss. Thus, although the suggestions and advice of state officials should be considered, such state regulators should not be authorized to make the final determination regarding the eligibility of an institution or in the formulation of the terms and conditions of a specific capital assistance plan.

Question 5. What is your view on adding a provision to S. 2531 which would require the FHLBB and FDIC to promulgate regulations implementing the provisions of the Capital Assistance Act?

Answer. We oppose the inclusion of a provision which would require the FDIC and the FHLBB to promulgate regulations. Although the agencies have the authority to promulgate regulations to implement the provisions of the proposed Act, we do not believe that such regulations should be required.

Under the provisions of the proposed Act, the form and nature of the capital certificates to be purchased from a qualified institution by the FDIC or the FHLBB and the form of consideration given by the Corporations for such instruments may be defined by the Corporations on a case-by-case basis. In addition, the Corporations are to establish terms and conditions with which institutions must comply in order to receive assistance under the Act.

In our view, a requirement that the FDIC and the FHLBB promulgate regulations under the proposed Act could restrict unduly the flexibility needed by the insurers. Such regulations would be generally applicable to all institutions under the jurisdiction of the insurer and could hamper the insurer's ability to tailor a capital assistance program for a particular institution and to establish the terms and conditions for the receipt of such assistance.

To ensure that the FDIC and the FHLBB have maximum flexibility to respond to the problems of individual institutions, the proposed Act should not require the insurers to promulgate regulations.

We are pleased to have this opportunity to assist the Committee in its consideration of the proposed Capital Assistance Act. Although we support this legislation as an interim measure, more comprehensive legislative reform is necessary to ensure the long-term viability of depository institutions. Toward ths end, we urge the Committee to expand the asset powers of thrift institutions and to enable commercial banks to offer more competitive products and services as contemplated by S. 1720.

Additionally, the federal supervisory agencies need increased regulatory flexibility to deal with troubled institutions. We, therefore, strongly support the provisions of S. 2532, the so-called revised Regulators' bill, to provide such expanded federal supervisory authority and increased possibilities for marketplace solutions to industry problems.

Sincerely,

C. T. CONOVER,
Comptroller of the Currency.

The CHAIRMAN. Gentlemen, we thank you very much for your patience here this morning and your testimony. We will have a large number of additional questions for you to respond to in writing. Thank you very much.

[Recess.]

The CHAIRMAN. The committee will please come to order. Mr. Mehle, you are listed as a panel. You are a panel all by yourself. We are happy to have before the committee now Mr. Roger Mehle, Assistant Secretary of Domestic Finance of the Treasury Department. If you would like to proceed?

STATEMENT OF ROGER W. MEHLE, JR., ASSISTANT SECRETARY, DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. MEHLE. Mr. Chairman and members of this distinguished committee, I am pleased to present the administration's testimony on S. 2531, the Capital Assistance Act of 1982, and S. 2532, the Deposit Insurance Flexibility Act.

The administration supports, in general, both bills. The President has endorsed a legislative proposal very similar to S. 2531. He has also endorsed the principal feature of S. 2532, the authorization of interstate and interindustry mergers of troubled thrift institutions and commercial banks. And, you will recall that in his testimony in October of 1981 before this committee, Treasury Secretary Regan gave administration support to the interstate and interin-

dustry merger provisions of your bill, S. 1720, the Financial Institutions Restructuring and Services Act.

We commend you, Mr. Chairman, for introducing these two new bills, and we commend the committee for considering them so expeditiously.

I would like to explain the reasons why the administration supports your capital assistance bill, S. 2531. I would also like to contrast some of the bill's most desirable features with certain undesirable features of the Net Worth Guarantee Act, H.R. 6267, which was passed by the House of Representatives on May 20. Lastly, I would like to comment on the principal provisions of S. 2532.

THE PRESENT EARNINGS PROBLEMS OF THE THRIFT INDUSTRY

We all recognize, as you did in your remarks preceding the introduction of S. 2531, that thrift institutions are paying more to obtain funds than they are earning on their mortgage loans and mortgage-related investments. As the Depository Institutions Deregulation Committee has raised interest rate ceilings and acted to create new deposit accounts paying market rates of interests to insure that thrift institutions have adequate resources, the cost of funds to the institutions has been rising. At the same time, their assets continue to be dominated by low-yielding fixed rate mortgage loans and mortgage-related investments made in prior years. In the second half of 1981, the average cost of funds for federally insured savings and loan associations was 11½ percent, as compared with the 10-percent average return on mortgage assets. Because of the long-term nature of many of these assets, and in part because of legal constraints, the average cost of funds has increased more rapidly than the average return on assets. Consequently, thrift institutions have for the past 18 months experienced earnings losses which have reduced their net worth accounts.

These conditions should not obscure the fact that the thrift industry is currently a viable industry. It has adequate cash flow from income on loans and investments, mortgage payments, net new deposits, and borrowings to carry on its business and to meet all obligations to depositors. In the first quarter of 1982, federally insured savings and loan associations increased their total assets by 2 percent and increased their outstanding mortgage loan commitments by 4 percent.

Preventing or slowing the erosion of the net worth of thrift institutions until they are earning profits is an appropriate policy. Once interest rates decline, the thrifts' average cost of funds will fall below their average return on loans and investments. Further, as interest rates decline, the market value of their mortgage loans and mortgage-backed securities will return to par, and they will no longer experience losses when they sell such assets.

CAPITAL ASSISTANCE BILL

Under S. 2531, qualified institutions with declining net worth could issue capital instruments—to the Federal Deposit Insurance Corporation in the case of mutual savings banks or to the Federal Savings & Loan Insurance Corporation in the case of savings and

loan associations—in exchange for FDIC or FSLIC obligations (or for any other consideration deemed appropriate by the agencies. The exchange of capital instruments for agency obligations need not involve cash, except for interest payments on the obligations and payments on the capital instruments out of future income of the institutions. The decline in thrift institutions' net worth would be slowed, thereby giving them "breathing room" to continue operations through the current high-interest rate-period.

The bill will give the FDIC and the FSLIC the ability to design capital instruments which constitute net worth in accordance with generally accepted accounting principles. (GAAP). This is an important point, for if the capital instruments do not constitute net worth under GAAP the statutory purpose of enhancing the financial condition of thrift institutions will be frustrated. The staff of the Financial Accounting Standards Board, which is the professional body responsible for promulgating GAAP, has informed the staff of the House Banking Committee that the guarantees that would be issuable under the Net Worth Guarantee Act would not constitute assets of the institutions receiving them and therefore would not constitute additions to their net worth under GAAP.

It is important to recognize other valuable concepts which S. 2531 embodies.

AGENCY OBLIGATIONS

By providing that the FDIC and the FSLIC may set the terms of capital instruments and provide the consideration for them S. 2531 continues the present statutory structure, which places the responsibility for insuring the soundness of thrift institutions and the insurance funds on the FDIC and the FSLIC. By contrast, H.R. 6267 would create a guarantee account at the Treasury and would make net worth guarantees issued under that act full faith and credit obligations of the United States and payable by the U.S. Treasury. The grant of the Federal Government's full faith and credit to obligations of the FSLIC and the FDIC would remove the financial constraints on their activities and would absolve the agencies of their responsibilities.

MINIMAL BUDGET IMPACT

By providing the deposit insurance agencies with the ability to grant noncash assistance, S. 2531 is a way of fulfilling the responsibility we all have to avoid increasing the Federal budget deficit and to lower interest rates. The reduction of interest rates is the single most important step which the Congress can take to restore the thrift industry to economic health.

AGENCY DISCRETION

S. 2531 confirms the broad discretion which the deposit insurance agencies have under current law to fashion relief for troubled institutions. The administration has consistently supported the FSLIC's present successful program of providing net worth to savings and loan associations by purchasing income capital certificates. By establishing only broad limits on the scope of the agen-

cies' assistance, the bill allows them to adapt their programs to the diverse conditions of thrift institutions and to develop criteria so that assistance will not be universally available.

S. 2532: INCREASED ASSISTANCE AND MERGER POWERS

Mr. Chairman, let me now turn to S. 2532 and comment on the elements which the administration considers most significant.

The bill provides greater options for agencies to arrange mergers and acquisitions of troubled institutions. For the rescue of FDIC-insured savings banks or commercial banks having assets of $500 million or more and which are closed or in danger of closing, section 106 of S. 2532 would authorize the FDIC to arrange sales of assets, mergers, and acquisitions with an FDIC-insured bank or an FSLIC-insured institution established by an out-of-State bank or holding company. Section 203, relating to emergency mergers of FSLIC-insured savings banks and savings and loan associations, is based on provisions of Chairman Garn's bill, S. 1703, and received the administration's support in October of last year. Although 203 is significantly different from section 106 in a number of respects, we have no policy objections to the different sections, given that the FDIC and the FSLIC each believe that the relevant section meets its objectives.

These two sections would enable the regulators to find a larger number of depository institutions willing to acquire or merge with troubled thrift institutions or commercial banks. The greater number of bidders should reduce the cost of Federal assistance by facilitating mergers and acquisitions. The legislation also promotes free market solutions to the problems of failed and failing institutions and minimizes Government regulation.

Importantly, S. 2532 expands the chartering authority of the regulators. It permits conversions to, and the chartering of, Federal stock savings banks for the acquisition of State-chartered mutual savings banks. The converted or newly chartered banks would remain insured by the FDIC, but would be regulated by the Federal Home Loan Bank Board. For many potential acquirers of troubled institutions, both a stock form of organization and a Federal charter are desirable features. Thus, the number of options for restructuring a failed or troubled mutual savings bank is increased under S. 2532.

Provisions of 2532 also broaden the assistance powers of the FSLIC and the FDIC. In the past, the administration has generally opposed the broadening of financial assistance language, because we believe that under present law, the Federal deposit insurance agencies have, in substance, the authority that they need.

We continue to believe that they do so, but we will not oppose the broadened assistance provisions of S. 2532, because action under the broadened assistance language would now take place in the context of the noncash capital assistance program of S. 2531, and because both agencies have demonstrated due regard for the soundness of management and the long-term viability of troubled institutions, not simply providing wholesale "bailouts" for all.

EXPANDED ASSET POWERS FOR THRIFT INSTITUTIONS

Mr. Chairman, I would like to make very strongly one last point. The administration believes that expanded lending and investment powers must be included in any legislation which expands the assistance powers of the Federal deposit insurance agencies. If we do not now establish a structure for the long-term viability of thrift institutions, the grant of expanded assistance powers, rather than being a remedy for the present short-term problems of the thrift industry, will become a long-term program of governmental assistance, to which the thrift industry and its regulators will have to resort during each business and interest rate cycle. Furthermore, we will continue to have a thrift industry burdened by out-of-date, complex laws and regulations which impede its members' ability to compete effectively in the present environment of rapidly changing innovations in financial services.

Therefore, we urge that this committee add to the present proposed legislation those provisions of title I of Chairman Garn's bill, S. 1720, which would give thrift institutions many of the same investment and lending powers that commercial banks now have. Providing thrift institutions with new investment and lending powers need not diminish their central role in providing financing for the housing sector. Real estate lending is their area of greatest expertise, and they are likely to continue expanding this activity. The ability to make a broader range of loans and investments should supplement their real estate lending and help the industry stabilize their earnings, in periods when there is strong demand for other services, such as commercial and consumer loans, but a relatively lower demand for mortgages.

Mr. Chairman, with the addition of the increased lending and investment powers of S. 1720, S. 2531 and S. 2532 would constitute a comprehensive legislative package that would fulfill a number of the administration's policy goals with respect to the thrift industry.

We urge this committee to approve these legislative measures, which are vital both for the short-term survival of many thrift institutions and for the long-run strengthening of the thrift industry as a whole.

That concludes my testimony, Mr. Chairman.

I will be pleased to answer any questions the committee may have.

[The complete statement follows:]

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m.
May 26, 1982

Testimony of the Honorable Roger W. Mehle
Assistant Secretary of the Treasury
(Domestic Finance)
Before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

I am pleased to present the Administration's testimony on S. 2531, the "Capital Assistance Act of 1982", and S. 2532, the "Deposit Insurance Flexibility Act".

The Administration supports, in general, both bills. The President has endorsed a legislative proposal very similar to S. 2531. He has also endorsed the principal feature of S. 2532, the authorization of interstate and interindustry mergers of troubled thrift institutions and commercial banks. And you will recall that in his testimony in October 1981 before this Committee Treasury Secretary Regan gave the Administration's support to the interstate and interindustry merger provisions of Chairman Garn's bill, S. 1720, the

"Financial Institutions Restructuring and Services Act". We commend you, Mr. Chairman, for introducing these two new bills, and we commend the Committee for considering them so expeditiously.

I would like to explain the reasons why the Administration supports your capital assistance bill, S. 2531. I would also like to contrast some of the bill's most desirable features with certain undesirable features of the "Net Worth Guarantee Act" (H.R. 6267) which was passed by the House of Representatives on May 20. Lastly, I would like to comment on the principal provisions of S. 2532.

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paying market rates of interest to insure that thrift institutions have adequate resources, the cost of funds to the institutions has been rising. At the same time, their assets continue to be dominated by low yielding fixed-rate mortgage loans and mortgage-related investments made in prior years. In the second half of 1981, the average cost of funds for federally insured savings and loan associations was 11.3%, as compared to a 10% average return on mortgage assets. Because of the long-term nature of many of these assets, and in part because of legal constraints, the average cost of funds has increased more rapidly than the average return on assets. Consequently, thrift institutions have for the past 18 months experienced earnings losses which have reduced their net worth accounts.

These conditions should not obscure the fact that the thrift industry is currently a viable industry. It has adequate cash flow -- from income on loans and investments, mortgage repayments, net new deposits and borrowings -- to

carry on its business and to meet all obligations to depositors. In the first quarter of 1982, Federally insured savings and loan associations increased their total assets by 2.0% and increased their outstanding mortgage loan commitments by 4.0%.

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The bill will give the FDIC and the FSLIC the ability to design capital instruments which constitute net worth in accordance with generally accepted accounting principles (GAAP). This is an important point, for if the capital instruments do not constitute net worth under GAAP, the statutory purpose of enhancing the financial condition of thrift institutions will be frustrated. The staff of the Financial Accounting Standards Board, which is the professional body responsible for promulgating GAAP, has informed the staff of the House

Banking Committee that the guarantees which would be issuable under the "Net Worth Guarantee Act" would not constitute assets of the institutions receiving them and therefore would not constitute additions to their net worth under GAAP.

It is important to recognize other valuable concepts which S. 2531 embodies.

1. Agency Obligations. By providing that the FDIC and the FSLIC set the terms of capital instruments and provide the consideration for them, S. 2531 continues the present statutory structure which places the responsibility for ensuring the soundness of thrift institutions and the insurance funds on the FDIC and the FSLIC. By contrast, the House-passed "Net Worth Guarantee Act" (H.R. 6267) would create a guarantee account at the Treasury and would make net worth guarantees issued under that Act full faith and credit obligations of the United States, payable by the U.S. Treasury. The grant of the Federal Government's full faith and credit

to obligations of the FSLIC and the FDIC would remove the financial constraints on their activities and would absolve the agencies of their responsibilities.

2. Minimal Budget Impact. By providing the deposit insurance agencies with the ability to grant non-cash assistance, S. 2531 is a way of fulfilling the responsibility of all of us to avoid increasing the Federal budget deficit and to lower interest rates. The reduction of interest rates is the single most important step which the Congress can take to restore the thrift industry to economic health.

3. Agency Discretion. S. 2531 confirms the broad discretion which the deposit insurance agencies have under current law to fashion relief for troubled institutions. The Administration has consistently supported the FSLIC's present successful program of providing net worth to savings and loan associations by purchasing Income Capital Certificates. By establishing only broad limits on the scope of the agencies' assistance, the bill allows them to adapt their programs to the diverse

conditions of thrift institutions and to develop criteria so that assistance will not be universally available.

S. 2532: Increased Assistance and Merger Powers

Mr. Chairman, let me now turn to S. 2532 and comment on the elements which the Administration considers most significant.

1. Greater Options for Agencies to Arrange Mergers and Acquisitions of Troubled Institutions. For the rescue of FDIC-insured savings banks or commercial banks having assets of $500 million or more and which are closed or in danger of closing, Section 106 of S. 2532 would authorize the FDIC to arrange sales of assets, mergers and acquisitions with an FDIC-insured bank or an FSLIC-insured institution established by an out-of-state bank or holding company. Section 203, relating to emergency mergers of FSLIC-insured savings banks and savings and loan associations, is based on provisions of Chairman Garn's bill, S. 1703, and received the Administration's support in October of last year. Although Section 203 is significantly different from Section 106 in a number of respects, we have no policy objections to the different

sections, given that the FDIC and the FSLIC each believes that the relevant section meets its objectives.

These two sections would enable the regulators to find a larger number of depository institutions willing to acquire or merge with troubled thrift institutions or commercial banks. The greater number of bidders should reduce the cost of Federal assistance. By facilitating mergers and acquisitions, the legislation also promotes free market solutions to the problems of failed and failing institutions and minimizes government regulatio

2. Expanded Chartering Authority. Importantly, S. 2532 permits conversions to, and the chartering of, Federal stock savings banks for the acquisition of state-chartered mutual savings banks. (The converted or newly chartered banks would remain insured by the FDIC but be regulated by the Federal Home Loan Bank Board.) For many potential acquirers of troubled institutions, both a stock form of organization and a Federal charter are desirable features. Thus, the number of options for restructuring a failed or troubled mutual savings bank is increased.

3. Expanded Assistance Language. Provisions of S. 2532 also broaden the assistance powers of the FDIC and the FSLIC. In the past the Administration has generally opposed the broadening of financial assistance language, because we believe that under present law the Federal deposit insurance agencies have in substance all the authority they need.

We continue to believe that they do so, but we will not oppose the broadened assistance provisions of S. 2532, because action under the broadened assistance language would now take place in the context of the non-cash capital assistance program of S. 2531, and because both agencies have demonstrated due regard for the soundness of management and the long-term viability of troubled institutions, not simply providing wholesale "bail-outs" for all.

Expanded Asset Powers for Thrift Institutions

Mr. Chairman, I wish to make very strongly one last point. The Administration believes that expanded lending and investment powers must be included in any legislation

which expands the assistance powers of the Federal deposit insurance agencies. If we do not now establish a structure for the long-term viability of thrift institutions, the grant of expanded assistance powers, rather than being a remedy for the present short-term problems of the thrift industry, will become a long-term program of governmental assistance to which the thrift industry and its regulators will have to resort during each business and interest rate cycle. Furthermore, we will continue to have a thrift industry burdened by out-of-date, complex laws and regulations which impede its members' ability to compete effectively in the present environment of rapidly changing innovations in financial services.

Therefore we urge that this Committee add to the present proposed legislation the provisions of Title I of Chairman Garn's bill, S. 1720, which would give thrift institutions many of the same investment and lending powers that commercial banks now have. Providing thrift institutions

with new investment and lending powers need not diminish their central role in providing financing for the housing sector. Real estate lending is their area of greatest expertise and they are likely to continue expanding this activity. The ability to make a broader range of loans and investments should supplement their real estate lending and help the industry stabilize its earnings in periods when there is strong demand for other services, such as commercial and consumer loans, but a relatively lower demand for mortgages.

Mr. Chairman, with the addition of the increased lending and investment powers of S. 1720, S. 2531 and S. 2532 would constitute a comprehensive legislative package that would fulfill a number of the Administration's policy goals with respect to the thrift industry. We urge this Committee to approve these legislative measures, which are vital both for the short-term survival of many thrift institutions and for the long-run strengthening of the thrift industry.

* * *

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Committee may have.

The CHAIRMAN. Thank you very much, Mr. Mehle.

One of the preconditions for assistance in the House and Senate bills is viability. In the House bill, it requires an institution seeking assistance to have reasonable prospects for long-term viability. The Senate bill, as you know, requires an institution to be solvent for 6 months or more.

It seems to me that the standard in the House is so vague that it would invite law suits against the FSLIC if they turned anyone down.

What's your opinion, as a former investment banker?

What does the House standard mean to you?

Mr. MEHLE. Generally speaking, we believe that the insurance agencies should have as much latitude as they think is appropriate for them.

Now, I recognize that they have another interest. They do not like to have so much latitude, particularly in a new statute, that it appears as if they are mandated to assist everyone and have absolutely no discretion to make any choices on the basis of management problems, long-run viability, or any other considerations.

I myself have some trouble with the word "solvent," because the word "solvent" has at least two meanings that are in common usage. One is that the entity in question can meet its cash obligations as and when they come due in the ordinary course of business. Another, which has been used in the context of the thrift industry and its difficulties, is that the net worth of the institution gets to zero. The two interpretations can come into conflict with each other. The point of both bills—S. 2531 and the "Net Worth Guarantee Act"—is to insure that good money is not thrown after bad, in order that an institution which is unlikely to survive, no matter what may be done, not be afforded assistance which will simply increase Government obligations and may require a cash outlay.

As between the two, I am not sure that I can pick the better one. I am generally in favor of giving the agencies as much discretion as they feel they need, but not more than they want, so I would defer to them for the choice.

The CHAIRMAN. Is the administration's support of S. 2531 unqualified, or do you have amendments that you would suggest?

Mr. MEHLE. We do not now have any amendments of a policy nature that we would suggest. Our support of S. 2531 as it now stands is unqualified, with the possible exception of some technical matters which do not get to the substance of the legislation.

The CHAIRMAN. Due to the lateness of the hour, you have had a long wait. But you gave a good testimony, and we'll let you off easy. There may be additional questions, however, from many members of the committee.

Thank you very much.

Mr. MEHLE. Thank you, Mr. Chairman.

[Additional comments submitted for the record can be found on page 494.]

The CHAIRMAN. Next I would like to invite to the witness table:

Mr. Michael D. Edwards, supervisor of banking in the State of Washington, and president of the Conference of State Bank Supervisors; and

Mr. John E. Malarkey, State bank commissioner in the State of Delaware, and a member of the board of directors of the National Association of State Savings & Loan Supervisors.

Mr. Edwards, would you like to begin.

STATEMENT OF MICHAEL D. EDWARDS, SUPERVISOR OF BANKING, STATE OF WASHINGTON; AND PRESIDENT, CONFERENCE OF STATE BANK SUPERVISORS

Mr. EDWARDS. Thank you, Mr. Chairman and members of the committee.

I am Michael D. Edwards, supervisor of banking for the State of Washington, and president of the Conference of State Bank Supervisors.

I wish to clarify that I am testifying on behalf of the conference, and not on behalf of my State administration, which has not made a position on this matter known at this time.

The Conference of State Bank Supervisors [CSBS] is a professional organization of State officials who charter, regulate, supervise the approximately 10,500 State-chartered commercial and savings banks in the Nation.

On the one hand, CSBS is pleased to have this opportunity to testify. On the other hand, we would rather that the state of the Nation's affairs had never come to the point where hearings such as this have become necessary.

Philosophically, the conference is opposed to direct Government assistance to failing institutions. Failure is as much a part of the economic system as is success. Yet, the threat which is currently posed goes beyond the institutions we regulate, to the very system under which we regulate. We are actors in a scene which, if played to the final curtain, may well mean the demise of the dual banking system.

HARD TIMES MAKE FOR HARD SOLUTIONS

Mr. Chairman, hard times make for hard solutions. Immediate assistance is required, of a type which will maintain the net worth of affected institutions. The final form of the assistance should give the Federal agencies a minimum of additional oversight responsibility, and no equity interest in the assisted institutions.

There is no reason that any destruction of the parallel State/Federal authorities within the dual banking system must flow from legislation such as this.

CSBS believes that the primary regulators should be the designated authority to determine the institution's long-term viability. The primary regulator, under whose constant watchful eye the institution operates, is the best judge of matters such as the quality of management, the prospect for long-term viability, and the need and probable impact of assistance under the Federal program.

In determining an institution's need for aid under an assisted program, CSBS believes tha the condition of the parent holding company should be factored into the decision, where the institution to be assisted is wholly owned by a holding company.

Within the context of our concerns, it is clear that the chairman has attempted to construct a reasonable approach to the serious

problem at hand. However, we believe that the approach taken in S. 2531 is not the best approach available.

Unlike the House-passed H.R. 6267, which uses a net worth guarantee to maintain troubled institutions at 2 percent net worth, S. 2531 slows, but does not halt, the decline in net worth.

We are also concerned that the insurance funds, already under pressure due to current unprecedented conditions, will be asked to bear an extraordinary commitment of their available resources to backing new capital instruments. The effect of such obligations would be to preclude the use of obligated reserves for expenditures related to assisted mergers.

Finally, the bill as now constructed assigns a role to the insuring agencies which goes far beyond the scope of the insurer's interest.

The bill freezes out the regulator who most closely supervises the institution, and restricts the management, which must make the institution profitable in the final analysis.

H.R. 6267, as passed by the House, does not suffer from these defects. The guarantees are contingent liabilities, and have no immediate adverse effect on the budget deficit. In making determinations respecting the eligibility of State-chartered institutions, State regulators are consulted. The restrictions placed on an aided institution are both minimal and reasonable.

H.R. 6267, which passed the House on a 272 to 91 vote, is the best available alternative to allowing the thrift industry to fail. While it is not perfect, it will meet the current and future needs without undue damage to the present financial system.

Therefore, CSBS endorses substituting H.R. 6267, the House-passed bill, for S. 2531.

Now, as to the Regulators' bill, CSBS urges this committee to substitute the House-passed version of the Regulators' bill, H.R. 4603.

H.R. 4603, which passed by the overwhelming vote of 371 to 46, is a more narrowly targeted emergency bill, which contains several safeguards necessary for the protection of the dual banking system. These include provisions which would:

First, subject institutions acquired under the legislation to State branching restrictions;

Second, insure that equal consideration be given to the type of institutions involved, their location, and recovery to insurance funds; and

Third, limit the emergency authority to allow interstate mergers and acquisitions to be applicable only to those types of insured institutions now in trouble.

H.R. 4603 gives the the FSLIC and the FDIC the authority that they will need to address the short-term thrift problem, while limiting the potential for lasting damage.

With S. 2532, we are now faced with a bill which awards the Federal insurance agencies even greater latitude to play havoc with the dual banking system and with State laws. Adding insult to inactivity, this bill would not only strip off the House-endorsed safeguards, but would make the continued meaning of the McFadden Act and Douglas amendment to the Bank Holding Company Act a matter of individual discretion for two men who have publicly shown wanton disregard for the principles embodied therein.

INTERSTATE ACQUISITIONS

Section 106 of S. 2532, entitled "Extraordinary Acquisitions," would give the FDIC complete discretionary authority to arrange the interstate sale of an insured bank with total assets of $500 million or more, if that bank were closed or in danger of closing.

This section is a direct assault on the present authority of the States. It would give the Chairman of the FDIC complete authority to determine when, where, and on what conditions the interstate holding company bank operations would be allowed.

It allows interstate acquisition of institutions, without requiring exhaustion of potential intrastate solutions, and contains no safeguards for the dual banking system.

By contrast, H.R. 4603 allows interstate sale only of closed savings banks and mutual savings banks over $2 billion in asset size. It contains a reoffer provision to allow the highest in-state bidder to match a higher successful out-of-State bid.

It would allow the appropriate bank supervisor to solicit offers from prospective purchasers.

Clearly, H.R. 4603 is far less destructive of State authority in this regard.

Section 106 does not require the concurrence of the primary regulator prior to the exercise of extraordinary emergency powers by the insuring agencies.

The primary regulators—the Comptroller of the Currency or Federal Home Loan Bank Board in the case of nationally chartered institutions, and the State regulator in the case of State-chartered institutions—are the only agencies with responsibility for protecting all public interest considerations, and have sole responsibility for determining institutional viability.

Authority for emergency interstate sale in this bill extends to all closed insured banks, in spite of the fact that there is no evidence that large numbers of commercial banks are experiencing difficulty.

This legislation is put forth as needed to deal with an emergency, as——

The CHAIRMAN. Mr. Edwards, could I interrupt you just for a moment? There is a phone call that I have to take, and I will be back.

[Recess.]

The CHAIRMAN. Excuse the interruption.

Please continue.

Mr. EDWARDS. Thank you, Mr. Chairman.

Now, this legislation is needed to deal with an emergency, as an exemption from existing statutory mandates. Therefore, it should be written and interpreted as restrictively as possible.

Section 102 gives the FDIC the authority to convert an insured savings bank into a Federal stock savings bank, notwithstanding State laws prohibiting such conversions or prohibitions on the charter of stock savings generally within the State. That's another disregard for State concerns.

In several States—New York being the best example—innovative State bank commissioners have been able to forestall the FDIC's mad rush to pedal mutual savings banks to bank holding compa-

nies on an interstate basis using these provisions. Instead, with a little hard work and innovation, attractive intrastate and like industry deals have been put together.

S. 2532 would substitute a slap in the face for a pat on the back as a reward for States taking a leadership role.

Section 203 provides for interstate and cross-industry merger and acquisition authority on very loose findings by the insuring agency.

Authority of the FSLIC to grant interstate or cross-industry transactions should be limited to cases where the institution is closed, in default or in immediate danger of default.

This section makes the need to minimize financial assistance required of the corporation the paramount consideration in allowing mergers and acquisitions. This provision renders the sequence of preferred transactions contained in the section meaningless since the institutions desiring to circumvent existing law, to enter otherwise unavailable markets, will always pay a premium to do so.

Therefore, section 203 should be amended to require that equal consideration be given to authorizing transactions according to the order of priorities and to minimizing the financial assistance required to the corporation. This important step was taken by the House in H.R. 4603.

The most important change in the regulators' bill added by the House of Representatives was in the form of an amendment offered by Congressman Stan Parris, of Virginia, unanimously adopted by the full committee, with the full agreement and approval of the Federal regulators.

That provision provided for the prospective McFaddenization of thrift institutions acquired by banks or bank holding companies. H.R. 4603 greatly lessened both the potential anticompetitive consequences and the potential for injury to the dual banking system in cross-industry acquisitions.

The Federal Reserve Board, in its recent approval of the first cross-industry acquisition, the *Scioto* decision, took what we believed to be the correct position. It required, as a condition to its approval, that the acquiring institution commit Scioto's branching to that permitted under the branching laws of the State of Ohio, as if Scioto were a commercial bank, along with some other key safeguards added in deference to the State, by insuring that an acquired thrift is subject to the same statutory provisions as a bank acquired by a bank-holding company and by limiting cross-industry acquisitions to individual emergency instances, the Federal Reserve Board has demonstrated a sensitivity to all of the problems surrounding the issue.

This committee would do well to take its lead from the Federal Reserve Board and the House in this matter, not from the limited interest pressed by the insuring agencies.

For all of these reasons, it is clear that Senate passage of H.R. 4603 is to be preferred over undertaking the numerous amendments which would be required to render S. 2532 acceptable to all concerned.

Now, as to a matter a little bit aside from this topic though related. If I might, for just a moment, in summary and in closing, to talk to you about emergency bills in this regard, they take care of

only the symptoms of our current economic malaise and new forces in the financial institution industry.

RATE-COMPETITIVE INSTRUMENT

In order to truly help, Congress must first vigorously support responsible monetary and fiscal policies and, secondly, provide traditional depository institutions with a rate-competitive instrument.

Now, everyone speaks to you about the first of these. Let me, just for a moment, address the second one.

Nationwide, money market mutual funds are bleeding numerous State and local communities of their economic life blood, to the tune of some $188 billion in assets. Infusions of assistance in the amounts which are discussed here pale by comparison.

The regulation Q run on thrifts and banks is the greatest single problem faced by the financial institutions industry today. The only way to insure the long-run viability of the depository institutions industry is to give it the pricing tools to compete.

Unless Congress or the DIDC acts to give depository institutions a rate-competitive instrument, the condition of the depositories as a whole will continue only to worsen.

Several States, including my own, have already recognized that the industry needs a rate-competitive instrument to survive and have passed legislation to that effect. Unfortunately, that legislation has no effect without DIDC approval. And that has been withheld as a matter of course.

I am asking you gentlemen to rewrite the Depository Institutions' Deregulation and Monetary Control Act to allow States, on an individual basis, to provide by statute for a rate-competitive instrument or an accelerated regulation Q phaseout.

In essence, I am asking you leave the rates to the States. Let this emergency exercise not only be one in which Congress underwrites the survival of those troubled institutions who deserve to survive, but one in which Congress gives healthy institutions the rate-competitive tools they need to remain healthy as well.

In conclusion, we hope that this committee sees fit to accept H.R. 6267 and H.R. 4603 in lieu of the bills currently before it or that you see fit to adopt amendments addressing the concerns we have outlined.

Our interests in this matter are in the public interest, as we know they are with you.

I'd like to say that this is a summarized statement of the Conference. I request that my whole statement be included in the record.

Thank you, Mr. Chairman I'll be happy to answer any questions.

[The complete statement follows:]

STATEMENT OF MICHAEL D. EDWARDS

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. Chairman, members of the Committee, I am Michael D. Edwards, Supervisor of Banking for the State of Washington and President of the Conference of State Bank Supervisors. I wish to clarify that I am testifying on behalf of the Conference and not on behalf of my state, the administration of which has not assumed a position on this matter at this time.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, regulate and supervise the approximately 10,500 state-chartered commercial and savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the most significant single source of educational and research services aimed at strengthening individual state banking departments.

The Conference is interested in any matter which has a direct bearing on the safety and soundness of the banking system as a whole, credit availability and bank performance in meeting public needs, and the maintenance of a viable, decentralized dual banking system.

On one hand, CSBS is pleased to have this opportunity to testify. On the other hand, we would rather that the state of our nation's affairs had never come to the point where hearings such as this have become necessary.

S. 2531--The "Capital Assistance Act of 1982"

Emergency legislation such as the "Capital Assistance Act" or the House-passed "Net Worth Assistance Act" is never desirable. It can only be necessary. Legislation such as this makes winners of no one. It only increases the survivors list.

CSBS rises in support of thrift assistance legislation, not because we want to, but because we have to. Our support is premised on the understanding that an exchange of financial instruments, rather than an actual capital infusion, will be the cornerstone of such thrift assistance.

Reflecting inflationary monetary and fiscal policies during much of the 1965 and 1979 period and consequent extremes in interest rates, thrift institutions of this nation are facing red ink and potential failures of unprecedented proportions. While mismanagement may have contributed in individual cases and usury or due-on-sale prohibitory laws have contributed in some states, the overriding cause of the industry's plight has been federal government action.

Philosophically, the Conference is opposed to direct government assistance to failing institutions. Failure is as much a part of our economic system as is success.

Yet, the threat which is currently posed goes beyond the institutions we regulate to the very system under which we regulate. We are actors in a scene which, if played to final curtain, may well mean the demise of the dual banking system.

Increased concentration of the financial institution industry and increased centralization of governmental control over the industry and the economy, the directions in which the current chain of events is leading us, are to be more feared and abhorred than a one-time government infusion.

Mr. Chairman, hard times make for hard solutions.

The problems of the depository institutions, particularly the thrifts, are too well chronicled for me to bother this Committee with the gory details. The Banking Committee has taken countless

pages of testimony on the imbalance between the low yielding portfolios, filled with long-term mortgages, and the current high cost of money. CSBS appeared before this Committee last year to discuss the massive outflows of funds suffered by traditional depository institutions at the hands of the money market mutual funds. The whipsaw of the money cost/portfolio yield mismatch and competitors not subject to interest rate control has brought the thrift industry to its darkest hour.

The safety and soundness of state-chartered mutual savings banks is in question, as well as S&Ls nationwide. In addition, threats to the safety and soundness of the thrift industry could well have a spill-over effect on the commercial banking industry, since the public often fails to distinguish between types of depository institutions. The potential liability of the FDIC and FSLIC, backed by the full faith and credit of the nation, is enormous.

Unless the current money cost/portfolio yield mismatch is addressed, the short-term picture is dismal and other steps with longer time frames are irrelevant.

Immediate assistance is required, of a type which will maintain the net worth of affected institutions.

In order to garner CSBS support, a federal assistance program must be cost effective, avoid a massive across-the-board cash subsidy and require the repayment of aid, if any.

The best way to ensure cost-effectiveness is to target a program narrowly to those which truly need assistance and have a high probability of being saved if they get it.

We believe that the bill's determination that the institution would have to be closed within the next six months without such aid,

but would survive with it, is a step towards an objective criteria for entry to the program. It is also important to determine that the institution's losses have been caused by government action rather than mismanagement and that the management of the institution is committed to its survival.

CSBS believes that the primary regulator should be the designated authority to determine the institution's long-term viability. The primary regulator, under whose constant watchful eye the institution operates, is the best judge of matters such as the quality of management, the prospect for long-term viability and the need for a probable impact of assistance under a federal program. Not only does CSBS believe this to be a better control over eligibility, but we believe it to be more consistent with the role and function of the agencies involved under our current system of financial institution regulation.

The final form of the assistance should give the federal agencies a minimum of additional oversight responsibility and no equity interest in the assisted institutions. There is no reason that any destruction of the parallel state/federal authorities within the dual banking system must flow from legislation such as this. The authority of the primary regulator should be kept intact and no equity interest should be taken by the government.

In determining an institution's need for aid under an assistance program, CSBS believes that the condition of the parent holding company should be factored into the decision, where the institution to be assisted is owned by a holding company. Not only will this ensure that public funds are not used where private funds are available, it will ensure against double-dipping in cases of

supervisory mergers or acquisitions.

Within the context of our concerns it is clear that the Chairman has attempted to construct a reasonable approach to the serious problem at hand. S. 2531 would slow the descent of net worths at many institutions, and would avoid a massive across-the-board cash infusion by using capital certificates.

However, we believe that the approach taken in S. 2531 is not the best approach available.

Unlike the House-passed H.R. 6267, which uses a net worth guarantee to maintain troubled institutions at 2 percent net worth, S. 2531 slows, but does not halt the decline in net worth. If we have already determined that it was not mismanagement which caused the problem, that management is committed to survival of the institution and that an institution is otherwise viable, why replace only a portion of the institution's losses, especially since we are not dealing with cash infusions.

We are also concerned that the insurance funds, already under pressure due to current unprecedented conditions, will be asked to bear an extraordinary commitment of their available resources in backing new capital instruments. Estimates of new commitments to the funds are $0.8 billion by the end of this fiscal year, $3.4 billion by the end of FY83 and $6.9 billion by the end of FY84. While not expenditures, the effect of such obligations would be to preclude use of obligated reserves for expenditures related to assisted mergers. Increases in obligated reserves could be handled by increasing FHLBB statutory borrowing authority from the Treasury. More reasonably, the problem could be avoided by establishing a separate fund as was done by H.R. 6267. Since in either method

the capital certificates would only be available for payment in case of liquidation, use of a separate fund would simply avoid tying down the insurance funds. Further, H.R. 6267 avoids the expenditure of $1.2 billion in interest required by S. 2531.

Finally, the bill as now constructed assigns a role to the insuring agencies which goes far beyond the scope of an insurer's interest. In addition to current regulation by the chartering agency, in order to receive aid, an institution must agree to comply with "all the terms and conditions established" by the insurer. These terms include compliance with the insurer's rules and regulations, submission and adoption of plans of operation, restrictions on operations and consent to supervisory action. Under such terms an institution must either change its charter or suffer burdensome dual regulation. Having unilaterally determined an institution is worthy of a capital instrument, the insurer is allowed extraordinary powers over the management of the aided institution extending to approving plans of operating the thrift. Thus, the bill freezes out the regulator who most closely supervises the institution and restricts the management which must make the institution profitable.

H.R. 6267, as passed by the House, does not suffer from these defects. That bill authorizes the insurers to guarantee a qualified thrift's net worth through the issuance of net worth guarantees. The guarantees are contingent liabilities and have no immediate adverse effect on the budget deficit. In making determinations respecting the eligibility of state-chartered institutions, state regulators are consulted. The restrictions placed on an aided institution are both minimal and reasonable.

H.R. 6267, which passed the House on a 272-91 vote, is the best available alternative to allowing the thrift industry to fail. While it is not perfect, it will meet current and future needs without unduly damaging the present financial system. Therefore, CSBS endorses substituting H.R. 6267, the House-passed bill for S. 2531.

S. 2532- The "Regulators' Bill"

On October 28 of last year, then-President of CSBS Sandy Bianchi appeared before this Committee and addressed our concerns regarding S. 1720. He concentrated on the potential for destruction of the dual banking system contained in that bill and addressed, at length, problems which the Conference had with the version of the Regulators' Bill contained therein.

I did not expect, when I became President of CSBS, that I would have to come before you and repeat those same concerns.

However, in light of the total disregard for our concerns shown by the introduction of S. 2532, bear with me, members of the Committee, as I go over, once again, several key concepts.

Any enthusiasm the Conference might feel in seeking or accepting proposed solutions to the short-term threat to deposit insurance funds is tempered by our belief that each state can and should determine the structure best suited to the needs of its citizens and economy. We believe that the dual banking system must be preserved and any solution to the current problems must be designed with this factor in mind. We favor legislation which would enable the insuring agencies to provide assistance where necessary and rebuild insurance funds if they approach depletion, as provided in part by

this bill.

Over the troubled last twelve months the States have time and time again proven themselves responsive to situations which have developed. We have proven ourselves adaptable and sensitive to the needs of the financial institutions in our States. In New York, in Minnesota, in Pennsylvania, in my own State of Washington and in others, state legislatures, state banking departments and the Governors and their executive staffs have shown that they could get the job done. Congress does not have to mind our business.

With all due respect, Mr. Chairman, why should the Senate take action at Bill Isaac's request when he becomes frustrated that states have done the job at hand. If the Senate really wishes to destroy the dual banking system, you can do it without trying to find justification in emergency legislation to protect the insurance funds.

As for CSBS, we are convinced that the public is best served by a decentralized financial institutions regulatory system that works.

CSBS urges this Committee to substitute the House-passed version of the Regulators' Bill, H.R. 4603, for S. 2532. H.R. 4603, which passed by the overwhelming vote of 371-46, is a more narrowly targeted emergency bill which contains several safeguards necessary for the protection of the dual banking system. These include provisions which would: (1) subject institutions acquired under the legislation to state branching restrictions; (2) ensure that "equal consideration" be given to the type of institutions involved, their location and recovery to insurance funds, and (3) limit the emergency authority to allow interstate mergers and acquisitions to be applicable only to those types of insured institutions now in trouble.

H.R. 4603 gives the FDIC and FSLIC the authority they will need to address the short-term thrift problem, while limiting the potential for lasting damage.

By a pair of letters, dated November 23, 1981 and January 28, 1982, CSBS urged Senate enactment of H.R. 4603, with the safeguards provided by the House of Representatives intact.

Instead, we are now faced with a bill which awards the federal insurance agencies even greater latitude to play havoc with the dual banking system and with state laws. Adding insult to inactivity, this bill would not only strip off the House-endorsed safeguards, but would make the continued meaning of the McFadden Act and Douglas Amendment to the Bank Holding Company Act a matter of individual discretion for two men who have publicly shown wanton disregard for the principles embodied therein.

Section 106 of S. 2532, entitled "Extraordinary Acquisitions," would give the FDIC complete discretionary authority to arrange the interstate sale of an insured bank with total assets of $500 million or more if that bank were closed or "in danger of closing".

This section is a direct assault on the authority of the states contained in the Bank Holding Company Act. It would give the Chairman of the FDIC complete authority to determine when, where and on what conditions interstate holding company bank operation would be allowed. It allows interstate acquisition of institutions without requiring exhaustion of potential intrastate solutions and contains no safeguards for the dual banking system.

By contrast, H.R. 4603 allows interstate sale only of closed savings banks and mutual savings banks over $2 billion in asset size. It contains a reoffer provision to allow the highest in-state bidder

to match a higher successful out-of-state bid. It would allow the appropriate state bank supervisor to solicit offers from prospective purchasers. Clearly, H.R. 4603 is far less destructive of state authority in this regard and should be substituted.

At the very least, Section 106 of S. 2532 should be amended to parallel H.R. 4603 by:

1. limiting FDIC authority to insured banks which are closed where the FDIC is appointed receiver;
2. providing an opportunity for unsuccessful in-state bidders to match successful out-of-state bids;
3. limiting FDIC authority to mutual savings banks and savings banks over $2 billion in asset size, and
4. providing for the participation of state authorities in the bid solicitation process where a state-chartered institution is in receivership.

S. 2532, as currently structured, gives the FDIC no reason whatsoever to explore potential intrastate solutions, particularly those which might prove cumbersome to the insurer. Institutions desiring to circumvent the law, in this case the Douglas Amendment, to enter otherwise unavailable markets will always pay a premium to do so. It is, in effect, authorizing and encouraging the insurers to accept a bribe to circumvent existing law and places the government in the position of auctioning off footholds to the highest bidder. Obviously, the FDIC will always be in a position of putting an institution out for interstate bids at the earliest possible moment, since higher bids will be received for institutions not yet in receivership. S. 2532 will, if enacted, maximize the number of interstate sales, opening the door for sale of viable institutions

at the FDIC's discretion.

The proper role of the government in the regulation of financial institutions has many aspects. Among the most important of these are the safety and soundness of institutions (one aspect of depositor security), maximization of rate of return, availability of capital for all sectors and geographic areas, maintenance of a viable and efficient system of intermediation, assurance of delivery of services and consumer protection. The function of the insuring agencies is very limited. They are in place to provide depositor security by monitoring institutional soundness (preventive) and paying off insured losses (curative). Elevation of the insurance function, and more particularly protection of the insurance fund over all other public interest considerations, is an unfounded, improper and distorted approach.

<u>Section 106</u> of S. 2532 does not require the concurrence of the primary regulator prior to the exercise of extraordinary "emergency" powers by the insuring agencies. The primary regulators, (the Comptroller of the Currency or FHLBB in the case of nationally chartered institutions and the state regulator in the case of state-chartered institutions), are the only agencies with responsibility for protecting all public interest considerations, and have sole responsibility for determining institutional viability. They can best judge all of the potential negative impacts on a case-by-case basis that must be accorded deference to insure that the tail (the insurance funds) doesn't end up wagging the dog (our effective system of bank chartering and regulation). It is important to remember that it operates to an insurer's benefit to close an institution at the earliest possible point after the institution has fallen below zero

net worth, thereby minimizing the insurer's losses. This is particularly true where sale of the closed institution to the highest bidder is an available remedy. This approach clearly does not allow for consideration of all pertinent public interests.

Section 106 authority for "emergency" interstate sale extends to all closed insured banks in spite of the fact that there is no evidence that large numbers of commercial banks are experiencing difficulty. The identified "emergency" is limited to insured savings banks. Because of the different character of the two types of banks, the different laws and regulations applicable and the simple fact that commercial banks are not facing an emergency, this distinction should be clearly drawn. The underlying idea that the largest institutions should be allowed to merge or be acquired interstate is dangerous when the potential concentration of the financial resources and credit allocation is considered, but it is even more so when the most powerful banks might be involved.

Therefore, the "emergency" authority granted the FDIC to allow interstate mergers and acquisitions should be limited to closed savings banks and mutual savings banks. This conforms the authority granted to the only demonstrated need for the expansion of FDIC's powers. By limiting the application of this Section, the potential for misuse of the expanded powers is greatly reduced without restricting the "flexibility" the FDIC claims it needs. This legislation is put forth as needed to deal with an emergency, as an exemption from existing statutory mandates. Therefore, it should be written and interpreted as restrictively as possible while still serving its purpose.

Section 102 of S. 2532 gives to the FDIC the authority to

convert an insured savings bank into a Federal stock savings bank, notwithstanding state laws prohibiting such conversions or prohibitions on the chartering of stock savings banks generally within a state. The sole reason that this provision has been added is to force charter conversion of institutions from state to Federal and from mutual to stock ownership in states where the FDIC has not been able to coerce the state banking commissioner into accepting interstate sales. Current Federal law provides that savings banks organized under state law may not convert from the mutual to the stock form of ownership.

In several states, New York being the best example, innovative state bank commissioners have been able to forestall the FDIC's mad rush to peddle mutual savings banks to bank holding companies on an interstate basis using these provisions. Instead, with a little hard work and innovation, attractive intrastate and like-industry deals have been put together.

S. 2532 would substitute a slap in the face for a pat on the back as the reward for states taking a leadership role.

Moreover, the FDIC has no authority to charter any institution. It is an insurance company. Allowing chartering determinations to be made by the FDIC, with its limited insurer's perspective, would be irresponsible. Giving the FDIC the authority to charter Federal stock savings banks, albeit through FHLBB charter issuance, will make this a revolutionary piece of legislation, indeed.

Section 203 of S. 2532 provides for interstate and cross-industry merger and acquisition authority upon the very loose finding by the insuring agency that "severe financial conditions exist which threaten the stability of a significant number of insured

institutions, or of an insured institution possessing significant financial resources." To entrust a broad grant of authority to an insurer, triggered by a very loose finding left to the insurer's sole discretion is an unjustifiable delegation of power.

Authority of the FSLIC to grant interstate or cross-industry transactions should be limited to cases where the institution involved is closed, in default or in immediate danger of default.

Further, the concept of institutional viability, rather than institutional stability, should be part of the triggering mechanism for all extraordinary "emergency" powers of insuring agencies. Viability speaks to an institution's ability to continue to exist, the true interest of the insurer.

As was noted with regard to Section 102, Section 203 does not require the concurrence of the primary regulator, either state or federal, prior to the exercise of extraordinary "emergency" powers by the insuring agencies. This is a particularly important safeguard, since these powers may be exercised in cases where institutions are not in receivership.

Section 203 makes "the need to minimize financial assistance required of the Corporation" the "paramount consideration" in allowing mergers and acquisitions. This provision renders the sequence of preferred transactions contained in the section meaningless, since institutions desiring to circumvent existing law to enter otherwise unavailable markets will always pay a premium to do so.

Therefore, Section 203 should be amended to require that "equal consideration" be given to authorizing transactions according to the order of priorities and to minimizing the financial assistance required of the Corporation. This important step was

taken by the House in H.R. 4603. In addition, H.R. 4603 provides that the Corporation shall not authorize a subordinate transaction under this subsection, where an acceptable offer of an amount equal to or greater than a reasonable estimation of the cost to the Corporation of liquidating (including paying the insured accounts of the insured institution eligible for assistance) has been received, the acceptance of which would cause the authorization of a preferred transaction pursuant to the order of preference..."

This approach insures the least breakdown of structure and function, while preventing inordinate drains on the insurance funds.

The most important change in the Regulators' Bill added by the House of Representatives was in the form of an amendment offered by Congressman Stan Parris of Virginia, unanimously adopted by the full Committee, with the full agreement and approval of the Federal regulators. That provision of H.R. 4603 reads, as follows:

> "Where a merger, consolidation, transfer, or acquisition under this subsection involves an insured institution eligible for assistance and a bank or bank holding company, such insured institution shall be subject to the conditions upon which a bank may retain or establish and operate a branch or branches under the laws of the States in which such insured institution is located. In addition, no insured institution acquired under the provisions of this subsection by either a bank or bank holding company shall move its principal office or any previously established branch office after it is acquired which it would be prohibited from

moving if the insured institution were a national bank."

By providing for the prospective McFaddenization of thrift institutions acquired by banks or bank holding companies, H.R. 4603 greatly lessened both the potential anti-competitive consequences and the potential for injury to the dual banking system in cross-industry acquisitions. Without such a provision the acquisition of a savings and loan association by a bank holding company would allow the BHC to "bankify" the S&L and branch statewide and interstate in circumvention of McFadden and Douglas. Despite the "emergency" nature of the legislation, the competitive advantage enjoyed by the acquiring BHC both in terms of asset powers and branching ability, would dictate subsequent erosion of McFadden Act and Bank Holding Company Act restrictions in these areas. It is clear that uncontrolled cross-industry acquisition would represent a major circumvention of current state and federal law.

In addition to the implications for state structural authority, cross-industry acquisition threatens to upset competitive balances by granting to a few acquiring institutions powers to engage in activities denied like institutions. If BHC acquisitions of S&Ls were permitted, the competitive advantage would be substantial. Increased pressure for a breakdown in the division of commerce and banking would logically follow.

In order to avoid wholesale acquisition of thrifts, widespread erosion of banking structure and increased pressure for industry-wide homogenization, cross-industry acquisition must be limited to institutions which have failed or are in immediate danger of failing and must include McFaddenization of acquired institutions.

The Federal Reserve Board, in its recent approval of the first cross-industry acquisition (the <u>Scioto</u> decision), took what we believe to be the correct position. It required, as a condition to its approval, that the acquiring institution commit, <u>inter alias</u>:

. "to limit Scioto's branching to that permitted under the branching laws of the state of Ohio, as if Scioto were a commercial bank;"

. "not to engage in any transactions that would be in violation of section 23A of the Federal Reserve Act, as if Scioto were a member bank, and"

. "to limit Scioto's activities to those permitted to federal thrift institutions currently under the Home Owners' Loan Act and to bank holding companies and their subsidiaries under section 4(c)(8) of the Act."

In addition, the Board reaffirmed its conclusion that, "as a general matter, the operation of a thrift institution by a bank holding company is not a proper incident to banking."

By ensuring that an acquired thrift is subject to the same statutory provisions as a bank acquired by a BHC and by limiting cross-industry acquisition to individual emergency instances, the Federal Reserve Board has demonstrated a sensitivity to all of the problems surrounding the issue. This Committee would do well to take its lead from the Federal Reserve Board and the House in this matter, not from the limited interest pressed by the insuring agencies.

For all of these reasons, it is clear that Senate passage of H.R. 4603 is to be preferred over undertaking the numerous amendments which would be required to render S. 2532 acceptable to all

concerned.

Related Matters

In introducing S. 2531 and S. 2532, Senator Garn noted that these bills are merely short-term solutions to long-term problems. Emergency bills such as these and H.R. 6267 and H.R. 4603 take care only of the symptoms, symptoms of both our current economic malaise and new forces in the financial institution industry. In order to truly help, Congress must:

1. Vigorously support responsible monetary and fiscal policies; and
2. Provide traditional depository institutions with a rate-competitive instrument.

Everyone speaks to you about the first of these. Let me address the second for a moment.

Nationwide, the phenomenal growth of money market mutual funds has represented the most massive translocation of funds, going from about 45 states to a handful of money market centers, this nation has ever experienced. They are bleeding numerous state and local communities of their economic life-blood, to the tune of 188 billion dollars in assets. Infusions of assistance in the amounts which you are discussing pale by comparison.

The "Reg. Q-run" on thrifts and banks is the greatest single problem faced by the financial institutions industry today. The ability of the average American to put his savings into the "Sears U.S. Government Money Market Trust", which has already attracted approximately 200 million dollars, spells doom for institutions without a rate-competitive instrument. The rumored comprise of exchanging some increased thrift-asset powers for a phase-out of the

differential is truly an inconsequential exercise.

Every day new unregulated competitors seek to enter the banking business through one legal loophole or another. To some extent these loopholes can be closed.

However, the only way to ensure the long-run viability of the depository institutions industry is to give it the pricing tools to compete. Unless Congress or the DIDC acts to give depository institutions a rate-competitive instrument, the condition of the depository industry as a whole will only continue to worsen. Depository institutions across the nation are constantly seeking avenues to circumvent rate restrictions within the law. The majority have realized that they can better afford an increased cost of funds than a massive loss of deposits.

Several states, including my own, have already recognized that the industry needs a rate-competitive instrument to survive, and have passed legislation to that end. Unfortunately, that legislation has no effect without DIDC approval and that has been withheld as a matter of course, largely because the thrift institutions in certain geographic areas cannot afford the anticipated increase in the cost of funds. That generally-accepted Washington, D.C. fact, gentlemen, simply does not hold water in many states. It is no reason to tie the hands of thrifts and banks alike in states such as mine, where the outflow is hurting institutions far more than any potential cost-of-funds increase.

I am asking you, gentlemen, to rewrite the Depository Institutions Deregulation and Monetary Control Act to allow states, on an individual basis, to provide by statute for a rate-competitive instrument or an accelerated Reg. Q phase-out.

In essence, gentlemen, I am asking you to leave rates to the states.

Let this exercise be not only one in which Congress underwrites the survival of those troubled institutions who deserve to survive, but one in which Congress gives healthy institutions the rate competitive tools they need to remain healthy as well.

I would be remiss if I did not, in the context of this testimony reiterate the strong concerns of CSBS about S. 1720, as introduced by Chairman Garn.

If this body gives to thrift institutions essentially all of the powers currently enjoyed by commercial banks, steps must be taken to account for different statutory and regulatory treatment in other respects. Most particularly, "McFaddenization" of the thrift industry must accompany "homogenization", in order that the dual banking system be preserved and so that thrifts are not given a competitive advantage over their bank competitors. As noted above, the Federal Reserve Board has recognized the need to take steps to level competition where industry barriers have been broken down. At the very least, any thrift which exercises any commercial lending power should be made subject to bank branching restrictions. Logic and equity dictate that you must either reject "homogenization" or fully subject the thrift industry to state authority on questions of structure, including divestiture of branches where mandated by state statute.

In addition, Congress should spell out that, beyond that which is provided in the Regulators' Bill, BHC ownership of S&Ls is not "a proper incident" to banking within the meaning of Section 4 of the Bank Holding Company Act. This would affirm statutorily the

finding of the Federal Reserve Board in the Scioto decision.

We find compelling the reasons to avoid the use of emergency legislation as an engine to pull industry restructuring through Congress.

Major changes in the structure and function of the system of financial institutions should not be undertaken as an easy solution to a short-term problem. Any "emergency grants of extraordinary authority" should be tightly drawn and strictly construed. By so doing, we believe that such legislation can be effective without incurring unnecessary harms.

In conclusion, we hope that this Committee sees fit to accept H.R. 6267 and H.R. 4603 in lieu of the bills currently before it or that you see fit to adopt amendments addressing the concerns we have outlined above.

Our interest in this matter is the public interest, as is yours.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me just comment on one thing quickly. Then, I will have some more questions for you later.

But I'm a little bit surprised that you would pick H.R. 4603. I can understand your differences of opinion on the regulators' bill that's proposed on the Senate side. H.R. 4603 was passed way last November, rejected almost in total by everyone concerned except the House, because it was greatly modified with a September sunset. It dies in September.

That was one reason I saw no reason to consider it quickly, because if you have a bill in place, whatever the provisions are, if you don't need to use it, fine, it's there, the $2 billion threshold and a number of other things. But I would prefer to look at your suggestions in the form of amendments, because I don't think H.R. 4603—certainly not with a sunset in September—it's even more ridiculous now than it was last November—or the threshold or excluding commercial banks. There are commerical banks that are in trouble, so there are a number of reasons that I refused to be bulldozed into just taking that from the House. It would have virtually been unused during that period of time.

So, we'll certainly consider your suggestions for amendments. But I might as well be blunt about it, I don't see any way to blindly accept H.R. 4603, because of some very serious defects, the three of them that I have mentioned.

Mr. EDWARDS. We also agree that the extension of the sunset should be made.

The CHAIRMAN. Mr. Malarkey.

STATEMENT OF JOHN E. MALARKEY, STATE BANK COMMISSIONER, STATE OF DELAWARE, MEMBER OF BOARD OF DIRECTORS, NATIONAL ASSOCIATION OF STATE SAVINGS & LOAN SUPERVISORS.

Mr. MALARKEY. Mr. Chairman and members of the committee, we welcome this opportunity to present to you the views of the National Association of State Savings & Loan Supervisors on the legislative proposals for restructuring financial institutions contained in S. 2531, the Capital Assistance Act of 1982, and S. 2532, the Deposit Insurance Flexibility Act.

N.A.S.S. & L.S. is the collective voice of 51 State and territorial savings and loan regulators. Our members supervise and examine over 2,000 State-chartered institutions with assets of approximately $150 billion.

As State regulators, we are keenly aware of the difficulties facing savings and loans today and are primarily concerned about the impact of the present economic decline on our Nation's depositories.

We know intimately both the effects of the current environment on our State associations and the national causes of these problems. However, both S. 2531 and S. 2532, as drafted, preempt the primary regulatory authority of the State Savings and Loan Supervisor over State-chartered Federal Savings and Loan Insurance Corp. insured institutions.

RESOLVING STATE LAW RESTRAINTS

It is our understanding, pursuant to negotiations between our association and the Federal Home Loan Bank Board, that the Federal Home Loan Bank Board is committed to resolving State law restraints involving the appointment of a receiver or a conservator for State-chartered institutions by providing for written State concurrence on a determination of insolvency with FSLIC override of State authority in the absence of State concurrence after 90 days.

It is clear from the language of the agreement that the dual supervisory interest in resolving the issue and receiver-conservator appointment under State law remain intact, with maximum flexibility preserved for the Federal insuring agency to override State law where circumstances require.

The result of our negotiations was to be perfecting language, which, as of this date, has not been incorporated into the statutory language of S. 1703, the Thrift Institutions Restructuring Act of 1981, or the comparable language contained in section 202(b) of S. 2532.

May I respectfully submit for the record a letter from the Federal Home Loan Bank Board detailing our agreement to amend the statutory provisions.

The CHAIRMAN. It will be so included.

[Copy of the letter follows:]

FEDERAL HOME LOAN BANK BOARD,
October 27, 1981.

MR. WILLIAM S. BERGMAN,
Executive Vice President, National Association of State Savings & Loan Supervisors, Washington, D.C.

DEAR MR. BERGMAN: This is to confirm our agreement with respect to S. 1703, the Thrift Institutions Restructuring Act of 1981. Specifically, with respect to Title IV, the Bank Board will support incorporation of language having the substantive effect of providing that:

(1) Under the extraordinary merger authority contained in the bill, a state chartered FSLIC-insured S&L May be merged, consolidated or have its assets and liabilities transferred to another insured institution or insured bank by the FSLIC only if the state authority having jurisdiction over the acquired institution approves in writing; provided, however, that such approval shall be unnecessary where the FSLIC, despite a good faith effort, has been unable to obtain such approval within 90 days of the institution's exhaustion of its net worth.

(2) Our proposed provisions relating to expansion of existing FSLIC receivership/conservatorship powers over state institutions shall be modified to state that, in addition to cases covered under present law, the FSLIC shall act as sole conservator or receiver of a state-chartered, FSLIC-insured institution only in the event the Bank Board determines, and the state authority having jurisdiction over the institution concurs in writing, that any of the grounds specified in section 5(d)(6)(A)(i), (ii) or (iii) of the Home Owners' Loan Act of 1933 exist with respect to the institution; provided, however, that if the state authority has not concurred within 90 days of receipt of notice of the Bank Board determination, the Bank Board shall have authority to appoint the FSLIC as receiver or conservator. If the state supervisory authority has submitted in writing his reasons for not concurring with the Bank Board's determination, then the Bank Board shall respond in writing prior to the appointment of a conservator or receiver.

(3) The provisions of Title IV shall be effective through and until 18 months from the date of enactment.

The final form of the amendatory language will be developed promptly by the Bank Board's staff, in consultation with NASS&LS. The final draft must be satisfactory to both NASS&LS and the Bank Board.

It is our understanding that Bank Board agreement to the above will result in NASS&LS and its individual directors completely supporting S. 1703 (including the amended provisions) with the exception of the provisions concerning due-on-sale clauses, which we understand will be generally supported, but in a manner different from the provisions proposed by the Bank Board. This support will extend to those provisions of S. 1703 incorporated in S. 1720.

Sincerely,

JOHN S. BUCHANAN,
Executive Staff Director.

Mr. MALARKEY. As to specific comments with respect to the legislative proposals, we desire to be constructive in our criticism and will address each bill separately.

S. 2531, the Capital Assistance Act of 1982, while capital assistance through capital instruments issued by the FSLIC is an affirmative step toward economic restabilization of the thrift industry, we cannot support any Federal proposal the direction of which is intended to foreclose all State supervisory authority over distressed State-chartered institutions.

The preemptive language of S. 2531 and S. 2532 violates both the principles of the dual system of financial institution regulation and the Federal Home Loan Bank Board's commitment to the State Savings & Loan Supervisors.

Two weeks ago, Chairman Pratt outlined a posture of supervisor cooperation between the Federal Home Loan Bank Board and the State Savings & Loan Supervisors in his testimony before the Senate Appropriations Subcommittee on HUD and Independent Agencies, stating—and I quote—

The Bank Board continues to seek improved cooperation between this agency and State savings and loan regulatory officials. In looking ahead, I can assure the subcommittee of our continuing support for the dual Federal-State charter system and, more specifically, for efforts to improve cooperation between the Bank Board and the State regulatory agencies within that system.

In our opinion, the provisions drafted by the Federal Home Loan Bank Board relating to extraordinary supervisory authority of the FSLIC contained in the Capital Assistance Act of 1982 and the Deposit Insurance Flexibility Act are contrary to this commitment to cooperation.

Our mandate as regulators is to preserve and protect the institutions which we supervise. We can only do this if given the opportunity to participate in the rehabilitative and regenerative process. Cooperation among all financial institution regulators is essential to preserve the thrift industry.

The empowering authority providing that, "Notwithstanding any other provision of State or Federal law and without limitation on any authority provided elsewhere in this act or the Homeowners' Loan Act of 1933, the Corporation, in its sole discretion, and upon such terms and conditions as it may provide," is overly broad in granting the Federal insuring agencies State supervisory jurisdiction over distressed, State-chartered institutions.

A discretion vested in the FSLIC will promote the present Federal Home Loan Bank Board policy to require a step incident to the receipt of capital assistance—conversion from State to Federal charter.

RESTRICTIONS

This *de facto* policy to restrict the issuance of capital instruments from federally chartered institutions or to undertake to require a State-chartered institution to convert to Federal charter to receive either capital assistance or participate in a supervisory "Phoenix" program is justified on the FSLIC's concern that its scarce resources, both financial and human, and its lack of flexibility with regard to State law render it unable to control the destinies of State-chartered institutions.

N.A.S.S. & L.S. believes that this is an unjustifiable stance of a Federal regulatory agency, which amounts to an overreaching by the Federal Home Loan Bank Board that is neither rationally based nor compelled by Federal interests.

As an example, the eligibility criteria for institutional qualification to receive capital assistance includes an agreement to comply with the all the terms and conditions established by the corporation, such conditions to include execution and implementation of resolutions and agreements to merge or reorganize, submission and adoption of plans and operations, restrictions on operations, and consents to supervisory action.

These conditions are tantamount to "federalization" of the assisted institution and will legislatively mandate continuity of this policy of Federal overreaching. Mr. Chairman and members of the committee, the receipt of capital assistance under S. 2531 will be conditional on a mandatory conversion of a qualified institution to Federal charter. We do not feel we can extend our full cooperation to our Federal counterparts when they promote a policy of manda-

tory charter conversion and will oppose any requirements for a State-chartered institution to convert.

Additional justification for the Federal preemption of State supervisory authority is the fear that unless judicial review of the Federal Home Loan Bank Board's determinations were rigidly circumscribed or eliminated, the FSLIC inevitably would be sued by every disappointed applicant, which would tax the resources of the Federal Home Loan Bank Board's legal staff enormously.

Further, it is contended that agency resources, which are already overburdened by the task of supervising a severely troubled industry, would be constrained to legally defend their determination.

N.A.S.S. & L.S. believes that participating institutions in any Federal assistance program must not, in exchange for capital instruments or net worth guarantees, be deprived of any protections provided under due process of law.

Due process of law for qualified institutions must be preserved in order to restrain arbitrary and capricious actions by the Federal insuring agencies.

The flexibility which the FSLIC claims it needs in regulating distressed institutions can be achieved by far less disruptive means.

The Department of the Treasury endorses this legislation for the reason that it does not complicate the difficult task of the insurance agencies by imposing additional ambiguous restrictions on their discretion, which can only distract the attention of the regulators and divert human resources from the task at hand. As a primary supervisory authority for over 2,000 institutions, we too, as regulators, face a difficult task and insist that to be effective any capital assistance to qualified State-chartered institutions must be undertaken through the cooperative effort of both State and Federal regulatory authorities with a minimum of preemption of State law and Government intrusion. Federal Home Loan Bank Board Chairman Pratt is in accord with this assessment and has stated before a House of Representatives subcommittee this year that economic conditions facing the industries make cooperation with State regulators imperative if we are to fulfill our supervisory responsibilities effectively.

It is the goal of the administration and the New Federalism to deliver authority over State interests and programs back to the State legislators and administrators, and it is inconsistent with this goal to preempt the State supervisory involvement in the oversight of distressed State-chartered institutions. Therefore, we must endorse H.R. 6267, the Net Worth Guarantee Act passed by the House of Representatives last Thursday. While we believe the language providing for the FSLIC to consult with the State Supervisors on eligibility determination involving State-chartered institutions will not mandate the joint cooperation that N.A.S.S. & L.S. believes to be in the best interests of the institutions, it is preferable to no consultation.

More importantly, S. 2531, as drafted, does not address the issue of the provision of capital assistance to a vital component of the thrift industry, State-chartered, State-insured thrift institutions. The American public does not distinguish between Federal- and State-insured institutions. Increased economic strain, exacerbated by capital assistance programs for federally insured institutions

will adversely impact State-chartered, State-insured institutions which, in turn, will adversely impact to the entire thrift industry. We must not underestimate the detrimental impact that the failure of State-insured thrift institutions will have on the confidence of the public in all thrift institutions.

S. 2531 is seriously flawed in its failure to include in its provisions, State supervisory input and the capital assistance to State-chartered institutions. For this reason, N.A.S.S. & L.S. actively supports Chairman St Germain's Net Worth Guarantee Act, as the legislation acknowledges and recognizes the ability of the State Supervisor to assist the Federal insuring agencies in resolving supervisory cases and extends net worth guarantees to State-chartered, State-insured depository institutions.

In addressing the issue of expanding the flexibility of Federal regulators to handle supervisory problems, we will reiterate the position taken before this committee on October 28, 1981. N.A.S.S. & L.S. believes that the points made to the committee are as valid today as they were last fall. It is our view that the supervisory authority is already in place to combine institutions which, if used with sensitivity, eliminates the need for increased Federal supervisory authority. Reference is made to Treasury Secretary Regan's remarks before this committee on October 19, 1981, where, on behalf of the administration, he stated:

> It would be a significant disservice to the public, if Congress were to provide some form of short-term assistance to thrift institutions, while leaving action on their fundamental problems to a later date or another Congress.

However, it is clear that there is a need for the legislation to provide a framework within which extraordinary authority may be bound and to clarify and restrict the uses of emergency merger and acquisition.

We therefore urge members of this committee to bear three things in mind when considering the merits of adopting the emergency thrift acquisition provisions of S. 2532 in their present form.

First, while acquisition of control of a State savings and loan association technically preserves the institution, merger or acquisition of its assets and liabilities does not. Thus, any Federal scheme which promotes mergers with non-State entities presents a threat to the State system.

Second, these preemptive sections of S. 2532 threaten not only State institutions, they federalize the supervisory process. Section 202(b) would override our supervisory authority to make a determination as to the solvency of an insured institution within our jurisdiction. Under current practice, before a State-chartered association is placed in liquidation or is merged for supervisory reasons, the FSLIC asks the State authority to declare the association in default or in imminent danger of default. In no instance in the past has the FSLIC proceeded with its assistance measures for State-chartered associations without State concurrence.

And third, cooperation between State and Federal regulators is essential to facilitate all supervisory transactions involving State-chartered associations. Given that some State associations must be acquired, merged or liquidated, we find no basis for excluding that association's primary regulator from the decisionmaking process.

Procedures contemplated in sections 202(b) and 203 of S. 2532 go beyond years of consistent and workable administrative practice and, in effect, make the Federal Government sole arbiter on supervisory matters.

We recognize that in some circumstances, the disappearance of a State-chartered association may be necessary, but we believe the burden of proof should rest with the Federal Government to show that a federalization of the entire supervisory process and one which threatens the continued existence of local or State-chartered institutions is the best practical approach. In this regard, N.A.S.S. & L.S. endorses H.R. 4603, the House version of the Deposit Insurance Flexibility Act, in that it provides for State supervisory consultation in making a determination in involving a State-chartered FSLIC, prior to the authorization of any "extraordinary" mergers, consolidations, transfers, or acquisitions.

CONCLUSION

In conclusion, let me stress to this committee on behalf of our member supervisors, that economic problems created here in Washington do not, in our view, justify the Federal Government in overturning the dual system. An essential characteristic of the dual system is the choice of a Federal or State charter and, thereby, the choice of a primary supervisor and a primary statutory code.

The existence of this choice, and the possibility of associations changing charters have resulted in more flexible and responsive supervision and better economic and social performance. By denying State supervisors the ability to regulate in a supervisory context, both S. 2531 and S. 2532 would result in the weakening of this dual system.

N.A.S.S. & L.S. is "founded on the principle that the State supervisors are equal partners in the dual system of savings and loan supervision." By working cooperatively to preserve the integrity of thrift institutions, both the State and Federal regulators can facilitate regulatory processes, preserve scarce resources, and better serve the public.

We appreciate the opportunity to present our view to the committee, and we have confined our comments to those issues critical to the role of the States in the supervision of the institutions they supervise.

[The complete statement follows:]

STATEMENT OF

JOHN E. MALARKEY

STATE BANK COMMISSIONER

STATE OF DELAWARE

ON BEHALF

OF THE

NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS

Mr. Chairman and Members of the Committee, we welcome this opportunity to present to you the views of the National Association of State Savings and Loan Supervisors ("NASS&LS") on the legislative proposals for restructuring financial institutions contained in S.2531, The Capital Assistance Act of 1982, and S.2532, The Deposit Insurance Flexibility Act. NASS&LS is the collective voice of 51 state and territorial savings and loan regulators. Our members supervise and examine over 2,000 state-chartered institutions with assets of approximately $150 billion.

As state regulators we are keenly aware of the difficulties facing savings and loans today, and are primarily concerned about the impact of the present economic decline on our nation's depositories. We know intimately both the effects of the current environment on our state associations and the national causes of these problems. However, both S.2531 and S.2532, as drafted, preempt the primary regulatory authority of the state savings and loan supervisor over state-chartered Federal Savings and Loan Insurance Corporation ("FSLIC") insured institutions. It is our understanding, pursuant to negotiations between our Association and the Federal Home Loan Bank Board ("FHLBB"), that the FHLBB is committed to resolving state law restraints involving the appointment of a receiver or conservator for state-chartered institutions by providing that:

> "The FSLIC shall act as sole conservator or receiver of a state-chartered, FSLIC-insured institution only in the event the Bank Board determines, and the state authority having jurisdiction over the institution concurs in writing, that any of the grounds specified in Section 5(d)(6)(A)(i), (ii) or (iii) of the Home Owners' Loan Act of 1933 exist with respect to the institution; provided, however, that if the state authority has not concurred within 90 days of receipt of notice of the Bank Board determination, the Bank Board shall have authority to appoint the FSLIC as receiver or conservator."

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[illegible] 1981

[illegible] capital instruments issued by [illegible] restabilization of [illegible] support any federal proposal the [illegible] state supervisory au[illegible] state-chartered institutions. The preemp[illegible] both the principles of [illegible] regulation and the FHLBB's [illegible] supervisors. Two weeks ago [illegible] supervisory cooperation between [illegible] and the state savings and loan supervisors in his testimony before the Senate Appropriations Subcommittee on HUD-Independent Agencies stating

"(T)he Bank Board continues to seek improved cooperation between this agency and state savings and loan regulatory officials,"...the current economic period has required greater cooperation with state regulators in the supervisory area--accordingly, we have shared with state regulators our information and projections with respect not only to troubled state-chartered institutions, but troubled federally chartered institutions as well. In addition, in January, the Bank Board and the National Association of State Savings and Loan Supervisors convened two conferences principally to discuss ways of improving federal-state coordination in supervisory resolution of troubled institutions. These conferences were attended by state supervisors from across the country, as well as senior staff and supervisory agents from the Bank Board in Washington and the field. In looking ahead, I can assure the Subcommittee of our continuing support for the dual, federal-state charter system and, more specifically, for efforts to improve cooperation between the Bank Board and state regulatory agencies within that system." (May 11, 1982 FY 1983 FHLBB Budget Request)

In our opinion the provisions drafted by the FHLBB relating to extraordinary supervisory authority of the FSLIC contained in the Capital Assistance Act of 1982 and the Deposit Insurance Flexibility Act are contrary to this commitment to cooperation. Our mandate as regulators is to preserve and protect the institutions which we supervise. We can only do this if given the opportunity to participate in the rehabilitative and regenerative process. Cooperation among all financial institutions regulators is essential to preserve the thrift industry.

The empowering authority providing that "(N)otwithstanding any other provision of State or Federal law, and without limitation on any authority provided elsewhere in this Act or the Home Owners' Loan Act of 1933, the Corporation, in its sole discretion and upon such terms and conditions it may provide", is overly broad in granting the federal insuring agency state supervisory jurisdiction over distressed state-chartered institutions. The discretion vested in the

[illegible] now the present FHLBB policy to require, as a stan[illegible] [illegible] receipt of capital assistance, the conversion from [illegible] charter [illegible] this de facto policy, to restrict the [illegible] capital instruments to federally chartered institutions [illegible] have to require a state-chartered institution to convert [illegible] charter to federal charter [illegible] capital assistance or partici[illegible] [illegible] "Phoenix" program is justified on the FSLIC's [illegible] scarce resources, both financial and human, and its [illegible] with regard to state law render it unable to [illegible] activities of state-chartered institutions. [illegible] that this is an unjustifiable stance of a federal regulatory [illegible] an overreaching of the FHLBB which is neither [illegible] based nor compelled by federal interests.

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> [illegible] to agree to comply with all the terms [illegible] established by the Corporation [illegible] assistance pursuant to this para[illegible] [illegible] without limitation on the [illegible] the frequency, execution and im[illegible] of resolutions and agreements to [illegible] and acceptance [illegible] restrictions on opera[illegible] repayment of assistance received, and [illegible] action.

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Mr. Chairman and the Members of this Committee, the receipt of [illegible] assistance [illegible] conditioned on the mandatory [illegible] the [illegible] to federal charter. We cannot extend our [illegible] to our federal counterparts when

they promote a policy of mandatory charter conversion and will oppose any requirements for a state-chartered institution to convert.

Additional justification for the federal preemption of state supervisory authority is the fear that "unless judicial review (of the FHLBB's) determination were rigidly circumscribed or eliminated, the (FSLIC) inevitably would be sued by every disappointed applicant, which would tax the resources of the FHLBB's legal staff enormously". Further it is contended that "agency resources which are already overburdened by the task of supervising a severely troubled industry" would be constrained to legally defend their determination. NASS&LS believes that participating institutions in any federal assistance program must not, in exchange for capital instruments or net worth guarantees be deprived of any protections provided under due process of law. Due process of law for qualified institutions must be preserved in order to restrain arbitrary and capricious actions by the agencies.

The flexibility which the FSLIC maintains it needs in regulating distressed institutions can be achieved by far less disruptive means.

The Department of the Treasury endorses this legislation for the reason that it "does not complicate (the) difficult task (of the insuring agencies) by imposing additional ambiguous restrictions on their discretion which can only distract the attention of the regulators and divert human resources from the task at hand".

As the primary supervisory authority for over 2,000 institutions we too, as regulators, face a difficult task, and insist that to be effective, any capital assistance to qualified state-chartered institutions <u>must</u> be undertaken through the cooperative effort of both state and federal regulatory authorities with a minimum of preemption of state law and government intrusion. FHLBB Chairman

recognizes the ability of the state supervisor to assist the federal insuring agencies in resolving supervisory cases, and extends net worth guarantees to state-chartered state-insured depository institutions.

S.2532 The Deposit Insurance Flexibility Act

In addressing the issue of expanding the flexibility of federal regulators to handle supervisory problems, we will reiterate the position taken before this Committee on October 28, 1981. NASS&LS believes that the points made to the Committee are as valid today as they were last fall. It is our view that the supervisory authority is already in place to combine institutions, which, if used with sensitivity, eliminates the need for increased federal supervisory authority. Reference is made to Treasury Secretary Regan's remarks before this Committee on October 19, 1981, where, on behalf of the Administration, he stated:

> In the past we have generally opposed such a broadening of financial assistance language for the federal deposit insurance agencies because we believe they already have the substance of the authority the language provides; and, most importantly, we do not want them to consider Congressional action as a mandate for accelerated spending on assistance to an industry frozen in a noncompetitive framework. We believe it would be a significant disservice to the public if Congress were to provide some form of short-term assistance to thrift institutions while leaving action on their fundamental problems to a later date or another Congress.

However, it is clear that there is a need for the legislation to provide a framework within which extraordinary authority may be bound and to clarify and restrict the uses of emergency merger and acquisition.

burden of proof should rest with the federal government to show that a federalization of the entire supervisory process, and one which threatens the continued existence of local, state-chartered institutions, is the best practicable approach. In this regard, NASS&LS endorses H.R. 4603, the House version of the Deposit Insurance Flexibility Act in that it provides for state supervisory consultation in making a determination involving a state-chartered FSLIC institutions prior to the authorization of any "extraordinary" mergers, consolidations, transfers or acquisitions.

In conclusion, let me stress to this Committee, on behalf of our member supervisors, that economic problems created here in Washington do not, in our view, justify the federal government in overturning the dual system. An essential characteristic of the dual system is the choice of a federal or state charter, and thereby the choice of a primary supervisor and a primary statutory code. The existence of this choice and the possibility of an association's changing charters have resulted in more flexible and responsive supervision and better economic and social performance. By denying state supervisors the ability to regulate, in a supervisory context, both S.2531 and S.2532 would result in the weakening of this dual system.

NASS&LS is "founded on the principle that the state supervisors are equal partners in the dual system of savings and loan supervision". By working cooperatively to preserve the integrity of thrift institutions, both the state and the federal regulators can facilitate regulatory processes, preserve scarce resources and better serve the public.

We appreciate the opportunity to present our views to the Committee. We have confined our comments to those issues critical to the role of the states in the supervision of the institutions which they license.

The CHAIRMAN. Thank you very much, Mr. Malarkey. We appreciate your testimony.

I understand your concerns about the dual role and the State consultation. I'm a little bit puzzled though by the support of capital maintenance, not on the details, House versus Senate, but on the concept of simply preserving most everyone, and I won't go into detail. I'm sure you heard most of the testimony this morning, but as a matter of principle, whether it's this industry or others, if we simply say all of you will be saved at a certain level with a 2-year phaseout, the rug can be jerked, or you continue to do it. I think that is unfair to especially the ones that are really struggling, really cutting costs, really trying to do the job, compared to some of those that Chairman Pratt talked about that are not making that similar effort, and that is a philosophical approach. The difference between the two bills, and I feel very strongly that we ought to try and help those that can be viable, that middle ground, not those who will survive under any circumstances and not those who will not succeed.

That's the category that capital maintenance, to me, gets involved in, that we will guarantee at least for a 2-year period those that continue to be a drag on the system, and there is simply no way they're going to be saved, even if interest rates come down.

So if you could quickly respond to that philosophical difference between the two, I'd appreciate it.

Mr. MALARKEY. I didn't understand the other capital plan to be of that nature, Senator Garn. Maybe I have an understanding on it.

The CHAIRMAN. When we get to 2 percent, we're going to hold them at 2 percent.

Mr. MALARKEY. I understand that part, but I don't understand the three groupings you called to my attention.

The CHAIRMAN. Ours is saying that at 3 percent we will start to give assistance, partial assistance, and as they go down, we will give them the incentive to try and cut costs and give them help, those who can be viable with that assistance. There's a basic difference between my bill—mine is capital assistance, theirs is capital maintenance.

Mr. MALARKEY. Under your bill, sir, wouldn't they continue to decline if they're losing money and, therefore, you would have to put up additional capital.

The CHAIRMAN. If they continued to lose money, yes, but the assumption is that the type of institutions that were described today, then there is incentive for providing more effort on their own to cut costs so that they stop the profit slide, and the assistance of 30, 40 and 50 percent is sufficient to stop that, and that if they are not willing to make those kinds of efforts, yes, you are correct, and that's exactly what I'm talking about. If they cannot be saved, there's lots of home builders in this country who would like to be saved, lots of automobile dealers. And I just don't believe in a philosophy where we say, regardless of how you are managed—that seems to me to be a penalty on those who really have been doing an excellent job, if they've got a competitor across the street, and he gets saved by capital maintenance, and they've worked real hard to cut their management salaries and done all sorts of things

to stay in business, and the guy across the street has still got his Cadillac and his country club membership and all of that, and he gets saved by a capital maintenance program.

Mr. MALARKEY. Don't misunderstand me, Senator. As an individual regulator, speaking for myself, I dislike any type of bailout, whatever you call it, however you do it.

The CHAIRMAN. Well, we're agreed on that.

Mr. MALARKEY. But beyond that, we have a problem today, and we've got to do something, and it just seems to us that the House version would perhaps be less costly in the long run. Hopefully, there are sufficient provisions in there, and I might add, with the help of state supervisors, since this is a State-chartered institution, only viable institutions are going to qualify.

The CHAIRMAN. I would hope both of your organizations would take another look. That doesn't mean I'm trying to tell you to change your testimony, but I am saying that I would hope you would consider some compromise rather than just that blanket. On the general principle—I'm not talking about individual provisions at this time, on that general principle, I think you'll have a very hard time in the Senate getting people to agree that we ought to have that blanket saving rather than trying to figure out some formula where we can help those that can be viable.

Gentlemen, I appreciate very much your testimony today and your patience, waiting through all of this time. We may have additional questions for you for response in writing, and I would invite additional comments on the subject that we have just had.

Thank you very much.

The hearing will stand in recess until 9:30 a.m., tomorrow, when we will hear additional witnesses on S. 2531 and S. 2532.

Now, however, I would like to convene the Banking Committee in a markup for an emergency purpose that has arisen on the floor. I would apologize for both of you gentlemen with all the activity going on in the background. I hope you are understanding. We've got the urgent supplemental on the floor and are trying to figure out how to get a markup together in the middle of the hearing.

So thank you very much for your patience.

[Whereupon, at 12:30 p.m., the hearing was adjourned, to reconvene at 9:30 a.m., Thursday, May 27, 1982.]

Response to questions of Senator Riegle (p.130) from Richard T. Pratt (FHLBB).

Assuming a moderate decline in market interest rates, we have estimated that the net increase in savings and loan association holdings of mortgage debt and mortgage backed securities will be about $194 billion during 1982-86. This would represent about 22 percent of the total rise in mortgage debt during the same period as estimated by Data Resources, Inc. on the basis of roughly comparable assumptions.

If all provisions of the Thrift Institutions Restructuring Act proposed by FHLBB were enacted, we estimate the increase in savings and loan holdings of mortgage debt and mortgage backed securities would be about 30 percent smaller, or $69 billion, during the 1982-86 period. However, this would still comprise 16 percent of the DRI total estimate.

Upon review I would like to add that the growth in home mortgage credit has declined from over 50 percent in the early 1970's to slightly over 20 percent in 1981. This reflects the competitive forces of the market which have deepened the commercial bank, pension fund, and insurance company holdings of mortgage credit. Although a more diversified thrift industry may invest a smaller proportion of its total funds in mortgages, this will not affect the aggregate availability of mortgage capital. The profitability of mortgage lending has already attracted nontraditional lenders such as Merrill Lynch, Sears, and Baldwin. Further deregulation and restructuring will increase the efficiency of capital markets and result in greater availability of mortgage capital.

The financial environment of this country has fundamentally changed. High interest rates have not created a temporary problem for thrifts. Without a commitment to enhance their asset powers, it is likely that few thrifts will survive regardless of whether interest rates decline and the housing and mortgage credit markets prosper again.

Response to questions of Senator Schmitt (p.134) from Richard T. Pratt (FHLBB).

Because of the wide variety of variables involved, estimates of the cost of paying deposit insurance and liquidating institutions compared to the cost of a capital assistance program over a period of years can provide only a general idea of orders of magnitude.

With Treasury bill yields in the 9-1/2 percent range, we estimate industry assets of about $100 billion would reach zero net worth during 1982-86 and therefore require some FHLBB action. Based on paying insured depositors and liquidating assets over a two-year period, prior experience suggests cost to FSLIC of about $5.0 billion. Under the same economic scenario, but with a capital assistance program, associations with about $86 billion in assets would reach zero net worth during 1982-1986. Utilizing FSLIC-assisted mergers to handle such cases and recent experience with such an approach, FSLIC cost would be about $4-1/2 billion.

With Treasury bill yields in the 13-1/2 percent range and no assistance program, industry assets of about $549 billion would likely reach zero net worth during 1982-1986. The cost to FSLIC of liquidating these institutions under the procedures noted above would be about $29.7 billion. With an assistance program, the assets of associations reaching zero net worth during 1982-86 is estimated at $479 billion. The cost of FSLIC-assisted mergers for such institutions would be about $24 billion if recent cost/asset relationships continue.

Response to questions of Senator Dixon (p.137) from Richard T. Pratt (FHLBB).

At the end of April 1982, 1,022, or 28 percent of all FSLIC-insured associations, had ratios of net worth to assets of less than 3 percent. These institutions held 34 percent of all deposits at insured associations.

Response to questions of Senator Riegle (p 147) from Richard T. Pratt (FHLBB)

Net Worth/Assets -- April 1982

Percent	Number
2-3%	525
1-2%	286
0-1%	145
0 or less	60

CAPITAL ASSISTANCE ACT AND DEPOSIT INSURANCE FLEXIBILITY ACT

THURSDAY, MAY 27, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m. in room 5302, Dirksen Senate Office Building; Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn and Brady.

The CHAIRMAN. The Banking Committee will come to order. We are commencing the second day of hearings on S. 2531 and S. 2532, the Capital Assistance Act of 1982 and the Deposit Insurance Flexibility Act.

We have a very distinguished first panel before us this morning: Edwin B. Brooks, Jr., president of Security Federal Savings and Loan Association of Richmond, Va., and vice chairman of the U.S. League of Savings Associations' Legislative Committee and past president; Robert B. O'Brien, Jr., chairman of the board of the Carteret Savings and Loan Association in New Jersey, and president of the National Savings and Loan League; Herbert W. Gray, chairman, Mutual Bank for Savings, Boston, and chairman, National Association of Mutual Savings Banks; and John E. Coles, president of the People's Savings and Loan Association, Hampton, Va., on behalf of the American Savings and Loan League.

Gentlemen, we are happy to have you with us this morning. Mr. Brooks, if you would like be begin.

STATEMENT OF EDWIN B. BROOKS, JR., PRESIDENT, SECURITY FEDERAL SAVINGS AND LOAN ASSOCIATION, RICHMOND, VA., VICE CHAIRMAN, U.S. LEAGUE OF SAVINGS ASSOCIATIONS' LEGISLATIVE COMMITTEE, AND PAST PRESIDENT

Mr. BROOKS. Thank you very much, Mr. Chairman. My name is Edwin B. Brooks, Jr., of Richmond, Va., and I appear here this morning on behalf of the U.S. League. I submit my full testimony, Mr. Chairman, and I would like it to be made a part of the hearing record.

The CHAIRMAN. All statements will be printed in full in the record.

Mr. BROOKS. Thank you, sir. I will try to be brief in my oral statement because I know you have several panels this morning.

We very much appreciate this opportunity to participate in your initiative, Mr. Chairman, in introducing the Capital Assistance

[illegible] particularly pleased to hear your remarks yesterday [illegible] ranking minority member, expressing the hope [illegible] committee and the Senate can move this legislation quick-

[illegible] hearings and was happy to see the under- [illegible] urgent need for S. [illegible] from other members of the [illegible] as well. [illegible] is certainly of the essence, and quick [illegible] welcomed by the savings and loan business. [illegible] League [illegible] your kind remarks, Mr. Chairman. [illegible] progress toward [illegible] consensus on the issues, present- [illegible] the thrift powers legislation. We need [illegible] investments if we are to avoid a repetition [illegible] and if we are to compete suc- [illegible] savings environment.

We [illegible] powers will augment rather [illegible] what we do best [illegible] provide mortgage credit. They will [illegible] your leadership in bringing [illegible] better understanding of these [illegible] and we extend our sincere thanks to [illegible]

[illegible] S. [illegible] in comparison with the [illegible] Act approved by the House, I can appreciate [illegible] percent coverage for [illegible] net worth level. But as a man- [illegible] executive I know will [illegible] that assistance. No man- [illegible] businessmen and [illegible] assistance. It invites con- [illegible] and severely cripples your ability [illegible] the established marketplace.

[illegible]

Yet, as you have recognized, prolonged high interest rates have temporarily sentenced [illegible] many [illegible] our institutions to net worth declines. We would hope that this committee might be able to modify S. [illegible] to provide some minimal last resort and temporary floor for the maintenance of net worth and then utilize a partial, 50 percent, [illegible] percent, or [illegible] percent, formula, as S. 2531 provides, above that threshold. This could buy some time for the hundreds of institutions Chairman Pratt testified yesterday would fall below current minimums, while at the same time preserving market discipline, competition, and encouragement to innovate.

In yesterday's testimony Chairman Pratt testified that abnormal supervisory oversight would not be anticipated with a broad national assistance program, however, we would appreciate some further amplification of that comment. We would ask that the committee request a more detailed statement on how the FSLIC would implement an assis[illegible] og[illegible] involving hundreds of institutions.

A fair eval[illegible] w[illegible] ther capital assistance will be meaningful, and hel[illegible] [illegible] ere shrinkage in the number of thrift institutions [illegible] vice to communities across the Nation might be [illegible] further clarification.

We would, however, like to applaud Chairman Pratt's statement that he would be comfortable living with a congressional instruction that assistance not be conditioned on an agreement in blank to merge.

In the same area of S. 2531, we suggest, as spelled out in our complete statement, that applicants for assistance be permitted to bring forth a business plan to demonstrate that they can meet a 6-month solvency test. We would agree with the testimony of Vice Chairman Martin that S. 2531 might be improved by adding some flexibility to the provision limiting assistance to no more than 100 percent of losses in the immediately preceding period.

Finally, Mr. Chairman, we would suggest that the committee consider taking this opportunity to eliminate the statutory net worth requirement which applies only to S. & L.s and not for the banking industry. That change could help dispel some of the problems of public perception about the condition of the thrift industry when conditions may improve, problems which arise because of rigid statutory net worth number.

I have appreciated, Mr. Chairman, this opportunity to present to the committee the views of the U.S. League, and I look forward to your questions, sir.

[The complete statement follows:]

STATEMENT OF EDWIN B. BROOKS, JR.
ON BEHALF OF THE U. S. LEAGUE OF SAVINGS ASSOCIATIONS
TO THE SENATE COMMITTEE ON BANKING, HOUSING
& URBAN AFFAIRS

May 27, 1982

MR. CHAIRMAN:

My name is Edwin B. Brooks, Jr. I am President of Security Federal Savings and Loan Association of Richmond, Virginia and appear today in my role as Vice Chairman of the Legislative Committee of the United States League of Savings Associations*.

The U. S. League and its 4,000 member savings and loan associations are deeply appreciative of this opportunity to testify on S. 2531, "The Capital Assistance Act of 1982," and S. 2532, a revised version of the so-called "Regulators' Bill."

*The U. S. League of Savings Associations has a membership of 4,000 savings and loan associations representing over 99% of the assets of the $650 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. The principal officers are: Roy Green, Chairman, Jacksonville, FL; Leonard Shane, Vice Chairman, Huntington Beach, CA; Stuart Davis, Legislative Chairman, Beverly Hills, CA; William B. O'Connell, President, Chicago, IL; Arthur Edgeworth, Director, Washington Operations; Glen Troop, Legislative Director; and Phil Gasteyer, Associate Director, Washington Operations. League headquarters are at 111 E. Wacker Dr., Chicago, IL 60601. The Washington Office is located at 1709 New York Ave., N.W., Washington, D.C. 20006 Telephone: (202) 637-8900.

We applaud your recognition, Mr. Chairman, of the need for immediate and effective legislation to address the deteriorating capital positions of our institutions. The Congress must provide direction to the federal supervisory agencies and put an effective capital assistance mechanism in place as soon as possible.

The priority we attach to S. 2531 does not diminish in any way our parallel request for a modernization in the powers of thrift institutions so that we might compete more effectively in a deregulated environment and continue to serve the savings and credit needs of the American public. As you know, we voiced our support for your innovative Title I of S. 1720 in testimony before the Committee last October and in several communications since then. We encourage you and the Committee to move forward with broader powers for thrift institutions.

Objectives of Capital Assistance Legislation

Effective legislation to provide capital assistance for ou institutions should seek to accomplish a number of important objectives. In your statement accompanying the introduction o S. 2531, Mr. Chairman, you identified several of our objective particularly well:

"Although it is important for our free enterprise system to permit unprofitable organizations to fail, it is critical that we maintain the stability and promote the growth of our financial system. Since a large number of thrift institutions are facing continued short-term reductions in net worth, Congress must consider expanding the merger assistance programs already instituted by the FDIC and the FSLIC to ensure that well-managed thrift institutions which have been following the dictates of government policies during the past five decades be given a chance to survive these temporary difficulties."

Expressed somewhat differently, the U.S. League recommends that you approach your task of framing capital assistance legislation with these objectives in mind:

- The Congress and the Government have a vital stake in maintaining the stability of our financial system -- not only because of the pledge behind federal insurance of accounts, but for the economic health of our nation.
- Well-managed private-sector financial institutions should have an opportunity to survive and continue to serve the public.
- While supervision of federal assistance mechanisms is appropriate and necessary, Government interference with management and operation of private-sector institutions should be kept to a minimum.

- Assistance plans which avoid direct Budget expenditures should be sought.
- It is appropriate that the Congress give direction to current supervisory attempts to cope with the problems of inadequate or declining net worth.
- Above all, "solutions" which permanently merge out of existence institutions which have performed well the functions expected of them are an inappropriate response to what are, in effect, temporary "problems" created by abnormally high interest rates and poor deregulation policies.

The Magnitude of the Problem

Though the plight of the savings and loan and savings bank businesses is well known to the Members of the Committee -- and we are reminded of it almost daily by the financial press -- it might be well to review the scope of the problem.

Mr. Chairman, in your introductory remarks for S. 2531, you set the stage well for understanding our difficulties:

> "Thrift institutions have served the savings and housing credit needs of consumers for decades. They have provided the means through which millions of Americans have attained the goal of homeownership. Unfortunately, because of the fact that they have served their mandated purposes so well, they have been less able than other financial institutions to withstand the economic turmoil and uncertainty of the past several years."

Last year, the savings and loan business suffered operating losses of more than $5 billion; in January 1982, it was another $900 million. (As a result, net worth of the industry nationwide has shrunk from $33 billion at the end of 1980 to roughly $27 billion as of December 31, 1981.) These losses are the consequence of the mismatch between the yield on mortgage holdings (9.88% in the second half, 1981) and the cost of funds (11.32%).

That the operating losses are large is undisputed. The magnitude of our long-term, fixed-rate mortgage portfolio returning inadequate yields is immense. These are assets of the highest quality -- since families meet their mortgage

payments religiously -- but they return too little to compete for savings deposits in today's short-term, high-rate environment.

As Exhibit 1 demonstrates, one-third of our assets return less than 9%; approximately two-thirds, less than 10-1/2%; and only one-sixth, more than 12%, the approximate level today of 91-day Treasuries. The portfolio "drag" is particularly severe in the Northeast and Midwest, where a legacy of below-market usury laws is most apparent.

With lending activity at a virtual standstill, improvement in the return on our mortgage portfolio proceeds at a snail's pace, while costs continue to climb and become "locked in," particularly with our market-rate 30-month Small Savers Certificate (which now comprises more than 20% of our savings base). Thus, negative earnings are assured for some period to come -- even if market rates should decline significantly in the near future, as we all so fervently hope.

The dollar figures -- representing, as they do, national averages -- tell only part of that story. The number of thrift institutions is shrinking dramatically. In 1981, 320 savings and loan assoications merged; 30% of these mergers were "supervisory" in nature, with 10% requiring assistance from the Federal Savings and Loan Insurance Corporation. Last year's merger activity was more than 2-1/2 times the previous record annual rate and it severely taxed the ingenuity of the FSLIC.

Our projections, as shown in Exhibit 2, indicate that, with interest rates approaching current levels, roughly one-fourth of the nation's savings and loan business (834 institutions with assets of $179.5 billion) will fall below the 2% net worth-to-assets level before the end of this year. Without Government assistance, another 700 institutions will reach this point in 1983 if these rate levels persist.

To liquidate so many institutions, with assets of that magnitude ($311.5 billion), would cost the Federal Government roughly $78 billion (since the low-yielding loan portfolios return only a portion of book value when sold in today's interest rate environment). It must also be appreciated that the economic loss is not avoided by liquidating the institutions; it is far less expensive to keep thrift institutions operating than to trigger that loss through liquidations.

To date, the FSLIC has sought valiantly to avoid liquidations and minimize their expenses while making good on their promise to Federally-insured depositors. Instead, they have pursued a policy of ad hoc restructuring through arranged mergers -- providing guarantees and assistance to the rescuers

in amounts less than liquidation costs. Thus, merging these institutions might cut costs to a range of $17.5 billion to $40 billion. But that assumes that enough merger partners can be found to absorb 1,500 or more institutions. If problems multiply as projected, mergers might soon become no cheaper than actual liquidations. (The FSLIC's sister fund, the FDIC, estimates a $1.7 billion cost for the half dozen savings banks it has assisted to date.) Needless to say, retrenchment of this magnitude implies a very substantial drain on the resources of the FSLIC, which currently maintains reserves of roughly $6 billion, with a market value of $4.9 billion.

Comments on S. 2531, As Introduced

The Capital Assistance Act of 1982, S. 2531, provides a statutory mechanism for addressing the temporary problems of deteriorating net worth in the thrift industry. It authorizes "periodic purchases of capital instruments" by the FDIC and FSLIC from qualifying depository institutions "for such form of consideration" as they may determine, with the capital instruments "deemed to be net worth for statutory and regulatory purposes." To qualify, an institution must have 20%

of its investments in residential mortgages (or mortgage-backed securities), have sustained operating losses during the two previous quarters, be judged to remain "solvent" for more than six months, agree to merge and satisfy other regulatory requirements, and have a net worth of 3% or less. Recipients of assistance are eligible for partial coverage of their losses in varying amounts depending upon their net worth level.

This proposed relief mechanism would incorporate in the statutes a program adopted last September by the Federal Home Loan Bank Board for federally-insured savings and loan associations. That program, known as "Income Capital Certificates," or ICCs, has been employed in several assisted mergers by the FSLIC over the past nine months. (It was developed following recommendations from a Special Committee of our organization.)

Experience with the FSLIC/FHLBB's limited regulatory assistance plan leads us to suggest a number of important changes for a more universal capital assistance plan, as envisioned by S. 2531.

Though the Congress through S. 2531 would authorize a capital assistance plan, the legislative draft in several instances surrenders to the agencies "sole discretion" to alter, and potentially frustrate, the accomplishment of the Congressional purposes. For example, under the draft, the FSLIC and FDIC are free "at any time" to rearrange the percentage of losses to be met by purchases of the capital instruments. Similarly, the agencies received under S. 2531 "sole discretion" to modify the terms of the "consideration" exchanged for the capital instruments issued by assisted institutions.

These grants of "sole discretion" to regulatory officials are an unnecessary and excessive delegation of Congressional authority, in our view. While a grant of authority to implement laws through rules and regulations is customary and expected, all parties involved in these transactions -- the Congress, the regulators and the insitutions -- are entitled to know what the program will, or will not, provide upon enactment.

We find particulary objectionable one of the qualifying standards set forth in the legislation: "The execution and implementation (before assistance is forthcoming) of

resolutions to merge or reorganize." Such "in blank" advance agreements to merge are demoralizing to the boards of directors and management of institutions which find themselves victims of prolonged high interest rates and hostile economic circumstances totally beyond their control. Indeed, this prerequisite to eligibility could be counter-productive. With the continued existence of their companies in constant jeopardy, boards and managers lack the incentive to work their way out from under the federal assistance program as quickly as conditions permit. Thus, a provision intended apparently to simplify the supervisory task might instead magnify supervisory problems.

The forced merger route has been utilized by the FSLIC and FDIC over the past eighteen months to deal with the gathering crisis in the thrift industry. Though it has succeeded in conserving the resources of the federal insurance-of-accounts funds, it is readily apparent that this regulatory device cannot cope with a problem of the magnitude we face today. The number of prospective partners willing and able to come to the rescue of thrift institutions failing to meet net worth minimums is simply inadequate. That is the fundamental reason this Committee and the Congress are considering capital assistance legislation as a priority matter.

Furthermore, the forced merger approach has had some questionable side effects. The legacy of usury laws and investment restraints has led to a concentration of thrift institution problem cases in the Northeast and Midwest, in particular. When local rescue bids were inadequate, the FSLIC sought out interstate solutions. These, of course, have prejudged your reconsideration of the traditional statutes governing out-of-state expansion of financial institutions and the potential consolidation of financial services in giant, multi-state holding companies.

When interstate rescues were impractical, the regulators invented an even more controversial approach: creation of multi-company "Phoenix" consolidations, or groupings of troubled thrifts. In some cases these displaced competent and experienced local management (and their hometown expertise particularly valuable for mortgage finance). The FSLIC has dictated that a majority of the board of directors shall be chosen by Washington. Roughly $20 billion in thrift assets to date have been placed under direct agency control. With their direct federal agency support, these Phoenixes pose formidable competitors for the remaining banks and thrifts operating in their market areas.

Thus, if the Committee is to stabilize the situation in the thrift industry and suspend effectively its ad hoc restructuring, we would strongly urge that you eliminate the invitation to forced merger found in the merger agreement language of S. 2531.

In another area, S. 2531 requires a determination that an applicant for assistance "will be solvent for six months, as determined by the Corporation in acordance with the methods for calculating net worth ...."

As you are well aware, the thrift industry can be characterized as one of the most interest-rate-sensitive businesses in our national economy. A determination of solvency in six months time is to a very large extent dependent upon the future course of interest rates. The agencies are in no better position than the rest of us to make such predictions.

If, however, you wish to retain this six month's standard in S. 2521, we would strongly recommend that applicants for assistance have an opportunity to formulate and present a business plan projecting more than six month's solvency which the Corporation may accept as meeting the requirements under S. 2531.

Denial of eligiblity, either initially or subsequently, will not eliminate the cost of disposing of the association. Some resolution of the problem case is still necessary, and that resolution will not be costless.

In some cases the regulator has already failed to find a merger partner to absorb the problem at a reasonable cost. Accordingly, more Phoenix-type aggregations may be the result despite the problems attendant on wholesale use of that procedure. When losses attributable to continuation of adverse economic conditions are the major element in a projected insolvency, denial of net worth assistance should not be automatic. Such inflexibility could be costly both to the institution and to the regulator.

The U.S. League is also concerned about the portion of this section stating that the agencies may make an eligibility determination "in accordance with the methods for calculating net worth." This would appear to give the FSLIC and FDIC the latitude to impose additional standards on applicants for assistance. We refer, in particular, to suggestions by the agencies that net worth aid ought to be measured by reference to the operating loss experience of a "peer group" of thrift institutions of comparable net worth. We consider comparisons based on peer group losses to be unworkable and unfair. (We were pleased when this approach was omitted in other portions of S. 2531.) Population trends, housing activity, competition for savings, legal restraints (particularly usury laws, restrictions on the exercise of due-on-sale clauses, and limitations on the use of adjustable-rate mortgages), the age

of the institution, and other factors create widely divergent operating climates at thrift institutions across the country. It is unfair to gauge assistance needed by an institution in New York City by the losses occuring at S&Ls of comparable net worth in California; it is not even possible to make such comparisons within the same Federal Home Loan Bank District -- since institutions in Illinois, for example, have had conditions quite different from those in neighboring Wisconsin.

Two more observations on the language of S. 2531, as drafted, bear mention. The sections authorizing purchase of capital instruments by the FDIC and FSLIC state that the agencies "may initially" purchase such securities. We would hope that the Committee would adjust this language so that the agencies might be encouraged to adjust any percentage limits upward as economic conditions dictate.

Our second observation concerns the ceiling imposed on purchases by the language, "the Corporation shall in no period purchase capital instruments from a qualified institution in the amount equal to more than 100 percentum of such institution's actual losses incurred for the immediately preceding period." This, in effect, prohibits the FSLIC and FDIC from restoring an institution to an adequate net worth level if it should begin the program with a substandard net

worth. For example, an S&L with 1% net worth might receive "consideration" to cover some of its current losses, but it could not have its net worth ratio increased to 1.5% or 2%.

Language might be added to permit the agencies, if they determine 100% is inadequate, to exceed this limitation of losses.

If the Congress wishes to achieve the objectives set forth at the beginning of this statement -- maintain the stability of thrift institutions, give well-managed institutions an opportunity to survive, minimize the need for direct Government agency interference -- we believe it would be preferable to permit the agencies to cover current losses sufficiently to restore and maintain net worth at a particular level -- say, 2%. The maintenance program need be only temporary in duration. But until the ravages of high interest rates are past, and institutions have an opportunity to restructure their balance sheets, an industry-wide "cushion" at a minimal, positive net worth level is a reasonable and ordered response to the deteriorating net worth problem.

The Need for a Treasury Backstop

While S. 2531 suggests a mechanism to assist our hard-pressed thift institutions, it does not -- in our judgment -- provide sufficient wherewithal to accomplish the task.

We can appreciate the reluctance of the Committee and the Congress to do anything which might suggest an increase in

federal expenditures. The forces on Wall Street which determine market rates of interest are preoccupied with the projection for a Federal deficit of $100 billion or more.

However, the existing resources of the FSLIC and the FDIC must be measured in relation to the potential scope of the assistance program. Thus far, the backing of the FSLIC fund has been sufficient to satisfy the leading accounting firms that the promissory notes exchanged for IOCs contitute assets of the several S&Ls assisted in that manner. However, as the section of this statement entitled "Magnitude of the Problem" details, a capital assistance program may need to accommodate hundreds, even a thousand or more, thrift institutions unless interest rates fall dramatically.

The existing credit line from the FSLIC to the Treasury is only $750 million. (We fully appreciate, of course, that the Congress, through H.Con.Res. 290, has reassured the public that its deposits will be protected by the Federal Government to the $100,000 insurance-of-accounts limit.) The Administration has declared unequivocally that it opposes any expansion of this line of credit.

Thus, the U.S. League believes that it is important that any Congressional approval of a capital assistance program should include a contingency account at the U.S. Treasury.

This account would not enlarge the deficit through Budget

outlays. Rather it would provide a guarantee for the "consideration" exchanged for the capital instruments issued by assisted institutions under S. 2531. In the unlikely event that the agencies would be forced to liquidate an assisted institution, it could be available to make good on the value of the assistance forwarded. The guarantee would be exercised for the benefit of the liquidator (the FSLIC and the FDIC), and the Treasury would stand in line following depositors and certificate holders to receive the proceeds of liquidation (thus diminishing somewhat the exposure of the guarantee account).

In terms of accounting acceptability, S. 2531 presumably would continue to rely upon the FSLIC's current understanding with its Income Capital Certificates. The FSLIC believes that it is necessary for the notes used to purchase ICCs to pay interest and be negotiable instruments. The U.S. League, however, believes that these features -- cash payment of interest and negotiability -- are unnecessary if the Congress has decreed (as is done elsewhere in S. 2531) that these instruments satisfy all regulatory (FSLIC, FDIC, SEC, etc.) and statutory net worth requirements.

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Statutory Net Worth Requirement

[illegible]

[illegible]

The net worth requirement for S&Ls began in the Depression years as a protection against loan defaults which would interrupt the cash flow needed to pay depositors. In recent decades, and even with the difficulties some of our borrowers face today, the repayment rates on our mortgage loans have been extraordinary; residential mortgage loans are an extremely dependable and secure investment. The exposure for the modern savings and loan association is not from delinquent loans -- but from high and volatile market rates which determine the rates paid on three-fourths of our liabilities. In this context, a net worth requirement may well be surplusage in the statutes.

S. 2532, the Revised Regulators' Bill

In our testimony last fall and in several letters to you, Mr. Chairman, we have stated that the U.S. League does not oppose clarified supervisory assistance powers for the FDIC and FSLIC, as contained in S. 2532, so long as such legislation is adopted in conjunction with broader investment and liability powers for our institutions.

Though the League has accepted the sequence of supervisory mergers set forth in S. 2531, we would repeat our recommendation that inter-industry acquisitions be undertaken only as a last resort. We remain completely opposed to bank or bank holding company takeovers of healthy thrift institutions. The U.S. League also remains concerned about language in Section 120 declaring that "the need to minimize financial assistance required of the Corporation shall be the paramount consideration" in arranging supervisory mergers. Strict application of this single consideration could be interpreted as an invitation to market-entry bidding by giant bank holding companies to the detriment of local institutions. We would support modification of this language to assure a balanced consideration of several factors in emergency thrift acquisition situations.

3. S. 2531, as written, resolves the problem of indemnification between the federal insurance funds for failures subsequent to a change in coverage by simply continuing the FDIC insurance for mutual savings banks converting to federal charters. If this new approach is accepted, and indemnification is again set forth in the statute, we would recommend complete indemnification for the FSLIC for five years for losses incurred following savings bank acceptance of FSLIC coverage.

Conclusion

The U.S. League welcomes your initiative, Chairman Garn, in introducing S. 2531, The Capital Assistance Act of 1982, and in making this subject a priority for legislative action. For capital assistance to be successful we strongly urge that you confine the discretion granted to the supervisory agencies so that you accomplish the objective of stabilizing conditions in the thrift industry. In particular, we oppose language in S. 2531 inviting expansion of forced merger activities. S. 2531 would be more effective, in our view, if assistance was available to maintain institutions at a fixed net worth level of, say, 2% of assets. A Treasury contingency account would help reassure the public and provide a backstop for institutions, rather than rely on the strained resources of the present Federal account insurance funds. In your examination of these issues, we further recommend that you consider repeal of the statutory net worth requirement for FSLIC-insured institutions -- a protection devised a half century ago to protect against loan losses, rather than the interest-rate risk which is the cause of current problems.

The U.S. League supports a Regulators' Bill (with a few revisions) provided that it is adopted in concert with broader powers for thrift institutions, such as those contained in Title I of S. 1720.

We have appreciated this opportunity to present our views on these issues of critical importance to the savings and loan business.

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[illegible]	[illegible]	[illegible]	[illegible]	% Cumulative [illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	4.22
7.00 - [illegible]	[illegible]	[illegible]	[illegible]	[illegible]
7.50 - [illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	33.33
[illegible]	[illegible]	[illegible]	[illegible]	46.76
[illegible]	[illegible]	[illegible]	[illegible]	58.30
[illegible]	[illegible]	[illegible]	[illegible]	64.95
[illegible]	[illegible]	[illegible]	[illegible]	71.47
[illegible]	[illegible]	[illegible]	4.33	75.80
[illegible]	[illegible]	[illegible]	[illegible]	80.21
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	3.23	87.21
[illegible]	[illegible]	[illegible]	2.52	89.73
[illegible]	[illegible]	[illegible]	[illegible]	91.73
14.00 - 14.49	8,654	458,352	1.77	93.50
14.50 - 14.99	5,320	463,972	1.21	94.71
15.00 - 15.49	5,782	469,754	1.18	95.89
15.50 - 15.99	4,150	473,904	0.85	96.74
16.00 - 16.49	3,701	477,605	0.76	97.50
16.50 - 16.99	2,332	479,937	0.48	97.98
17.00 and over	10,001	489,938*	2.04	100.00

[illegible] $489,966

*[illegible] may not add to total because of rounding

EXHIBIT # 2

CAPITAL INFUSION REQUIRED, ASSUMING A MID-RANGE INTEREST RATE SCENARIO*

	No. of ASSNS ISSUING ICCs	% of ASSNS ISSUING ICCs	ASSETS HELD by ASSNS ISSUING ICCs IN BILLIONS	ICCs ISSUED In Qtr.	ICCs ISSUED Cumulative
2nd Q '82	467	12.3%	$ 105.6 B	$ 1,310 M	$ 1,310 M
3rd Q '82	601	15.9	120.1 B	503	1,813
4th Q '82	834	22.0	179.5 B	857	2,670
1st Q '83	1,086	28.7	232.9 B	1,407	4,077
2nd Q '83	1,245	32.8	262.7 B	1,240	5,317
3rd Q '83	1,308	34.5	277.9 B	1,002	6,319
4th Q '83	1,520	39.0	311.5 B	1,463	7,782

(*Six-month Treasury rates averaging 12.6% in 1982, 11.7% in 1983)

S. 2532, the Deposit Insurance Flexibility Act, would provide the FDIC, the FSLIC, and the NCUA with increased powers and flexibility in dealing with troubled financial institutions. Our major concern about S. 2532 is that it not be fashioned to be unduly restrictive. We would not want this legislation to inhibit the development of voluntary mergers.

We know the members of this committee share our concern about the cost of supervisory mergers to the FSLIC and the FDIC. The introduction of S. 2531 and S. 2532 is evidence of that concern. These bills provide for remedial medicine aimed directly at the financial problems facing the thrift business.

We hope that the committee would agree with us that the regulatory agencies should use their presently existing authority whenever possible to provide preventive medicine. The most promising zero budget preventative medicine is the voluntary merger.

VOLUNTARY MERGERS

Most of the thrift mergers of the past 2 years have been voluntary. In these cases institutions have joined forces to provide improved economies of scale, improved marketing efficiencies, and improved long-term profitability.

The utility of voluntary mergers as a means of reducing the need for supervisory mergers and the future dependence on the capital assistance contemplated here today is severely limited by the political considerations which have prevented interstate and interindustry mergers on a voluntary basis. To restrict voluntary mergers to intrastate and intraindustry arrangements will result in greater dependence on capital assistance and supervisory mergers.

The voluntary merger is a private sector solution to the thrift problem. We suggest to this committee that it is not sound public policy to have the Federal Government arbitrarily restricting the private sector business decisions and causing increased reliance on Government assistance. We, therefore, urge this committee in passing S. 2532 to make clear to the regulators that the legislation is not intended to restrict voluntary mergers.

Mr. Chairman and members of the committee, we have been reluctant to come to you to ask for short-term assistance. We would not do so if we were convinced that there are any reasonable alternatives. In our judgment, doing nothing now and allowing continued erosion of the financial conditions of a substantial part of our depository system runs the risk of a much more expensive, less controllable cost in the months ahead.

In closing, I would again urge this committee to look at the long-run asset restructuring needs of the thrift industry and favorably act on the thrift powers contained in S. 1720 as well. Thank you for the opportunity to appear before you today.

[The complete statement follows:]

those institutions that have provided the financing for housing through this period of stress.

Before turning to the two bills before us today, I want to take a moment to express again our great appreciation to Chairman Garn for introducing S. 1720. The National League testified in support of the expanded asset powers contained in this bill on October 21, 1981. I want to reiterate our strong support for S. 1720 and to share our hope that these asset powers can be combined with the two bills that are the subject of the hearing today.

We believe it is imperative that the Congress act now to provide the thrift industry with those asset powers contained in S. 1720 in order to assure that we can compete effectively in the future. While short-term assistance is necessary to help us through the current economic environment, and we support the Capital Assistance Act of 1982, long-term assets powers are absolutely essential if we are to emerge as strong, viable institutions able to continue our housing role. We, therefore, urge this Committee to combine S. 1720 with S. 2531 and S. 2532, and to favorably report these bills. The time to act is now so that we may plan and implement these powers and services as soon as possible.

Since the early 1930s, there has been a well understood policy of the federal government to assume substantial responsibility for the stability of the nation's financial intermediary system. The government further assumed the responsibility of at least encouraging, if not assuring, that there would be a stable supply of credit for housing.

These policies have at times been explicit--at other times, implicit—in actions taken by the Congress over the last fifty years.

From the creation of deposit insurance, a federal thrift system, secondary market facilities, and a host of other measures, up to and including the enactment of H. R. 4986, the Congress, and in particular, the Banking Committee, has assumed responsibility for the safety and soundness of depository institutions, for the security of the deposit insurance funds, and for a national housing policy that seeks to maximize the opportunity for homeownership. The bills pending before this Committee, S. 2531 and S. 2532, represent a continued commitment to the goals of financial stability for the housing and thrift industry which are in a near-crisis state.

The savings and loan industry—taken as a whole—lost about $5 billion in 1981, reducing the combined net worth or reserves of the industry from $32 billion a year ago to approximately $27 billion today. While it is true that the degree of financial stress varied from place to place and from one institution to another, it would be a mistake to assumed that the problem is regional in nature. No savings and loan is immune from the effects of paying a higher rate to savers than it receives from borrowers. The losses that result eat away at the institutions's net worth.

The cause of this problem--and its almost unique applicability to thrift institutions—is well understood by this Committee, but apparently is not understood elsewhere. To put it simply, we got into this fix by doing what we were required to do by law and regulation, and

by what we were encouraged to do by public policy. Savings and loans have been, as they were created to be, the primary source of long-term mortgage credit in this country. They have provided mortgage credit in the form of long-term, fixed-rate loans.

Beginning about four years ago, the market and the Congress told us we were not paying a fair rate of return to our depositors. As a result, market-sensitive instruments were created to stem disintermediation and "give the saver a fair shake." Ten years ago we were severely chastised for objecting to a five-year phase-out of rate ceilings on savings. Well, we have been paying an increasingly higher rate and an increasingly volatile rate on savings. The net result is we hold the 6, 8, and 10 percent fixed-rate loans the government wanted us to make, and we are paying our depositors an average rate of 11-1/2 percent while the average yield on our mortgages is ten percent.

To date, the "solution" to the thrift problem has been to merge institutions in some cases with an infusion of capital or with an FSLIC "hold harmless" guarantee to the acquiring institutions against losses from the low-yield assets of the acquired thrift. There seems to have been an assumption by the government and the Congress that, in time, the problem would go away—i.e., that the thrifts will be merged quietly until interest rates fell and the problem solves itself. The Administration and the Congress until very recently by their silence have implied that the merger solution is cost free. Both assumptions are in error. The problem isn't going away. In 1981, there were three FDIC-assisted mergers and 23 FSLIC-assisted mergers costing each agency about

$1 billion. The potential cost to FSLIC from its private commitments and from the future mergers it will be required to arrange will be even more costly.

It may well be, Mr. Chairman, that some substantial degree of consolidation of the depository system is inevitable--given marketplace changes, technological innovations, and changes in consumer demands and expectations for financial services. One could argue that this consolidation would eventually affect all segments of the depository network. We are, therefore, prepared to accept the notion that a restructuring of the system and a degree of consolidation is inevitable, but the process of "natural selection" that would occur in a stable economic environment will not be achieved in the present climate.

Even if the merger process could go on indefinitely, the costs would be high. Continuing the present rate of assisted mergers may very well require direct financial infusion from Treasury. Far from a no-cost solution, the present course of action is potentially a very costly solution.

We do not believe that the supervisory merger process by itself is an adequate or the most desirable solution. While the merger process has been successful in avoiding the worst of all outcomes--liquidation of insured institutions--it has clearly not done the job in terms of restoring public confidence. Virtually every supervisory merger has been headlined in the press as a failure. The supervisory mergers have had an adverse effect on the public's confidence in thrift institutions generally as evidenced by the $25.4 billion savings outflow we

experienced in 1981 compared to a $11.7 billion inflow in 1980. Congress did respond to this problem partially by enacting the Congressional Resolution reaffirming expressions of the government's commitment to the insurance of accounts. For this we are very grateful to Chairman Garn and others on this Committee. Public confidence in the whole structure of the thrift industry is very much at issue here, and ultimately in the public's confidence in the nation's financial system.

It should be obvious that the current interest rate environment will make near-term profitability impossible. Indeed, if rates stay where they are, 1982 will be as bad or worse than 1981. If there were any reasonable expectation that interest rates would decline sharply to, say, a six-month MMC rate of 8 percent and a 30-month rate of ten percent and stay there, we would not be here today.

We had hoped that the Congress and the President would by now have the government's fiscal house in order, which is the ultimate and only permanent solution to our problems. We can, however, no longer wait for this to occur. While we would prefer to work out our problems through our own means rather than coming to Congress to ask for assistance, we have come to the conclusion that we have no other choice, but to seek temporary assistance.

S. 2531

S. 2531, introduced on May 14, 1982 by Senator Garn, would authorize FSLIC and FDIC to purchase capital instruments from qualifying institutions for the purpose of increasing the capital and, therefore, the net worth of these institutions. The bill provides for a "50-40-30"

capital infusion plan for assistance to institutions with a net worth at or below 3 percent. In addition to the net worth requirement, institutions qualifying for the assistance would have to (1) have incurred losses during the previous two quarters; (2) have at least 20 percent of their assets invested in mortgages; and (3) be able to remain solvent at least six months. In addition, assisted institutions would have to comply with the terms and conditions established by the financial regulators.

We commend the Chairman for providing for assistance to institutions beginning at the 3 percent net worth level. This is an extremely desirable provision. It will allow the FSLIC and the FDIC to begin assistance to institutions before they reach extremely critical levels of net worth. We believe this flexibility is important in ensuring stronger, more viable institutions in the long run.

By providing capital infusion while the institution is at the level of 3 percent net worth, the FSLIC will allow an institution to take the best advantage of the assistance and to stabilize itself in a better net worth position. We hope that this flexibility will be used by the FSLIC to enable viable institutions to return to profitability in a shorter time than would otherwise be the case.

<u>Full Faith and Credit</u>

We would suggest, however, that the bill be modified to provide that the full faith and credit of the United States stands behind the guarantee of net worth provided under the legislation. While the Administration and the Congress have already pledged the full faith and

credit of the federal government to ensure the ability of the FDIC and the FSLIC to protect depositors, we believe that this should be clearly spelled out in this legislation. This will ensure that the capital instruments provided for in the bill do the job intended, and are accepted by the public as reliable instruments. Without such guarantees, there could be less confidence in the capital certificates and ongoing debate in the markets and the media over whether the resources of the FDIC and FSLIC are adequate to cover the contingent liability of the certificates if large numbers of institutions fail. This could only exacerbate current doubt in the minds of consumers and investors about the stability of the financial system and given impetus to the "silent run" syndrome that has occurred in the past. We would urge the Committee to provide this guarantee in the legislation when it is reported out by the Committee.

It is not possible for any of us to predict the level of operating losses our industry will experience over the next 12 to 24 months, since this is almost exclusively a function of general interest rate behavior. Should current rates prevail, we question whether the insurance agencies should prudently incur the contingent liability resulting from even the partial indemnification contemplated by S. 2531. We believe, therefore, that the full faith and credit provision is important to provide assurances to the market, the public, and the institutions that the program enacted by Congress will work.

While it is certainly desirable that the insurance agencies rely on their own resources in assisting insured institutions, what we are

suggesting is a "back-up" to those resources. Given the language in S. 2531 that the FSLIC notes are to be redeemable only in the event of liquidation, a full faith and credit does not involve a major financial threat to the budget.

Transferability

While S. 2531 makes the necessary statutory changes to ensure that the capital certificates will qualify as net worth, there is an ambiguity as to the treatment of the ICCs and promissory notes in the event of a subsequent merger. We would suggest to the Committee that a technical amendment be added to explicitly state that in the event that an institution having received assistance decides to merge with another institution, the capital notes are transferable to the successor institution. Such a provision should include language authorizing the agency to require redemption of the ICCs on an accelerated basis if the acquiring institution is not itself sustaining operating losses.

As we have stated previously, we would rather not be here today under these circumstances. However, the economic situation is such that we felt it necessary to support a short-term assistance program for the thrift industry. Having reviewed the prospects for economic recovery and the political and practical realities of other forms of assistance, such as warehousing of mortgage loans or direct federal financial assistance, we believe S. 2531 is a workable, and achievable program to provide short-term assistance to the savings and loan industry.

S. 2532

S. 2532, the "Deposit Insurance Flexibility Act", would provide the FDIC, the FSLIC and the NCUA with increased powers and flexibility in dealing with troubled financial institutions. Among other things, this legislation would clarify FHLBB authority to authorize or require conversion of associations from mutual to stock form, charter stock institutions, provide assistance to prevent default of associations and to allow emergency interstate and interindustry mergers if such action is necessary. S. 2532 sets guidelines for emergency acquisition in the following sequence: first, between like institutions in the same state; second, between like institutions in different states; third, between institutions of different types in the same state; and fourth, between institutions of different types in different states. Similar powers are authorized for the FDIC and the NCUA.

The National Savings and Loan League believes that healthy thrifts should be permitted to branch, merge and acquire across state lines. In addition, we support cross-industry mergers and acquisitions, provided it's a two-way street; that S&Ls have an equal opportunity to acquire banks. We believe that such mergers and acquisitions for healthy institutions would provide a means of preventing future strain on the FSLIC funds. It provides a wider range of options to prevent healthy institutions from deteriorating to the point that FSLIC assistance is required.

In view of the NSLL policy as outlined above, our major concern about S. 2532 is that it not be fashioned to be unduly restrictive. We

would not want this legislation to inhibit the development of voluntary mergers.

We know the members of this Committee share our concern about the cost of supervisory mergers to the FSLIC and FDIC. The introduction of S. 2531 and S. 2532 is evidence to that concern. These bills provide for remedial medicine aimed directly at the financial problems facing the thrift industry. We hope that the Committee would agree with us that the regulatory agencies should use their presently existing authority wherever possible to provide preventive medicine. The most promising zero budget preventitive medicine is the voluntary merger. Most of the thrift mergers of the past two years have been voluntary mergers. In these cases, institutions have joined forces to provide improved economies of scale, improved marketing efficiency and improved long-term profitability.

The National League has encouraged the Bank Board to expedite the processing of merger applications. We are pleased with the actions the Board has taken recently in this regard.

The utility of voluntary mergers as a means of reducing the need for supervisory mergers and the future dependence on the capital assistance contemplated here today is severely limited by the political considerations which have prevented interstate and interindustry mergers on a voluntary basis. To restrict voluntary mergers to intrastate and intraindustry arrangements will result in greater dependence on capital assistance and supervisory mergers.

The voluntary merger is a private sector solution to the thrift problem. We suggest to this Committee that it is not sound public policy to have the federal government arbitrarily restricting the private sector business decisions and causing increased reliance on governmental assistance. We, therefore, urge this Committee in passing S. 2532 to make clear to the regulators that the legislation is not intended to restrict voluntary mergers.

In general, the National League supports the powers that have been requested by the regulatory agencies; however, we do have some further concerns that we believe can be accommodated in the context of the legislation they have proposed. To minimize the possible threat to the dual banking system, we recommend that Congress urge the regulators to seek mergers of like charters and to consult with state regulators where state-chartered institutions are involved. The federal regulators should be encouraged to use S&L holding companies with state-chartered S&L subsidiaries as an alternative merger vehicle to converting an S&L to a federal charter for that purpose.

Emergency acquisitions of state-chartered S&Ls in another state by multiple S&L holding companies have the advantage of permitting the retention of the state charters of acquired associations. We believe that the preservation of the state charters in emergency cases should be given this high priority by the FSLIC in order to avoid erosion of the dual chartering system.

Section 203(a) of S. 2532 adds a new subsection (m) to section 408 of the National Housing Act (section 408 is the "Savings and Loan Holding Company Act") which authorizes the FSLIC to merge insured institutions eligible for assistance pursuant to section 406(f) with, or transfer their assets to, other S&Ls or banks either intra- or interstate in accordance with a series of priorities stated in the new subsection. The new subsection would also permit "any company" to acquire control of such institutions or to acquire their assets.

We interpret the words "any company" to include a multiple savings and loan holding company. We believe that the proposed new subsection (m) should be amended to make specific reference to multiple savings and loan companies, and to further make it clear that such holding companies may acquire eligible S&Ls across state lines in emergency cases. We also recommend that the Committee approve interstate acquisitions of S&Ls by multiple S&L holding companies in non-emergency cases.

Conclusion

Mr. Chairman and Members of the Committee, we have been reluctant to come to you and ask for a short-term assistance program. We would not do so if we were convinced that there are any reasonable alternatives. In our judgment, doing nothing now and allowing a continued erosion of the financial conditions of a substantial part of our depository system runs the risk of much more expensive, less controllable costs in the months ahead.

In closing, I would again urge this Committee to look at the long-run asset-restructuring needs of the thrift industry and favorably act on the thrift powers contained in S. 1720 as well.

Thank you for the opportunity to appear before you today. I look forward to your questions.

The CHAIRMAN. Thank you, Mr. O'Brien.

Mr. Gray?

STATEMENT OF HERBERT W. GRAY, CHAIRMAN, MUTUAL BANK FOR SAVINGS, BOSTON, MASS., CHAIRMAN, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

Mr. GRAY. Mr. Chairman, members of the committee, my name is Herbert W. Gray. I'm chairman of the National Association of Mutual Savings Banks and chairman of the Mutual Bank for Savings in Boston, Mass.

I appreciate the opportunity to present the views of the savings bank industry on S. 2531, the Capital Assistance Act, and S. 2532, the Deposit Insurance Flexibility Act. In addition, I would like to reiterate the savings bank industry's strong support for the broadened asset and liability powers for thrifts contained in S. 1720.

The National Association heartily applauds the development of proposals for dealing with the rapidly deteriorating conditions of the Nation's savings banks and savings and loan associations. Our industry has been severely impacted by unprecedented disintermediation and bottom-line losses in a continuing destructive interest rate environment. As a result, we have urged the development and implementation of a comprehensive Federal program to address the thrift industry problems.

Mr. Chairman, these two acts, together with the broader asset and liability powers contained in S. 1720, would, in large measure, constitute such a program.

In our judgment, the present regulatory policies are not an adequate response to the deepening problems facing thrift institutions. The primary means of addressing these problems has been forced mergers. This approach raises major public policy concerns. If it continues unabated, it will lead to the reshaping of the financial institution structure of this country by regulatory fiat, eliminating many community-oriented thrifts and effectively nationalizing a major segment of the thrift industry.

MERGERS BECOMING EXPENSIVE

The adverse publicity accompanying a continuous wave of forced mergers threatens to undermine confidence in the soundness of the entire financial system. Indeed, it has already triggered a silent run at many depository institutions.

Finally, reliance on forced mergers will become increasingly expensive. This could eventually endanger the deposit insurance funds and deepen the Federal budget deficit.

The capital assistance programs contained in S. 2531 are intended to alleviate the pressure on the Federal regulators to arrange supervisory mergers. We have serious reservations, however, regarding the adequacy of the assistance formula. S. 2531 would slow down, but hardly halt, the erosion of net worth and the resulting process of forced consolidation.

Accordingly, we urge that S. 2531 be revised to direct the agencies to provide a higher level of support to troubled institutions as follows:

First, institutions with net worth below 2 percent of assets should receive assistance in an amount sufficient to maintain net worth at 2 percent for a specified time, in order to provide a breathing space for all involved.

Second, institutions with net worth between 2 and 3 percent of assets should receive assistance equal to some percentage less than 100 percent of their actual losses to slow and hopefully halt their net worth decline.

Third, institutions with net worths above 3 percent could receive assistance at the sole discretion of the Federal regulators whenever the regulators felt it to be in the public interest and consistent with the purpose of the act.

While we have philosophical differences with the regulators on the issue of forced mergers, we have always supported market-determined mergers, because of the benefits they offer to the institutions involved and to the communities they serve. Mergers ordained by regulators, however, are quite another matter. It was, in our view, never the intent of Congress that the administrators of insurance funds have the responsibility for restructuring the industry in which deposits are insured. The issue of thrift industry consolidation should be settled by Congress after careful deliberation and not by regulators. In line with this view, we object to the provision of the bill allowing the regulators to condition the availability of capital assistance upon the execution of agreements to merge or reorganize. The problems confronting thrift institutions stem in very large part from Government policy. Federal housing policy has required thrifts to invest heavily in fixed rate long-term mortgages. In recent years, Federal economic policy has failed to restrain inflationary forces and this has resulted in a climate of sharply higher and volatile interest rates.

We urge that the legislation be amended to impose reasonable limits on the powers of the Federal regulators to insist on agreements by management to merge and consolidate as the price of receiving capital assistance. I can assure you that no savings bank manager that I know of wants Federal assistance. I'm sure that given it, they will do their best to work out of it as quickly as possible.

In my written statement there was a reference to the particular problems of savings banks which are not insured by Federal agencies. I would urge you to read it. I will not comment on it further at this time.

OPTION OF RETAINING FDIC INSURANCE

The National Association also wants to express its support for S. 2532. The major change in this version of the regulators' bill, in our opinion, is the inclusion of provisions which will grant a savings bank the option of retaining FDIC insurance upon conversion to a Federal charter. For months we have been seeking action to end the *de facto* moratorium on savings bank conversions to Federal charters. We are particularly indebted to you, Mr. Chairman, and to Senators D'Amato, Heinz, and Proxmire, for efforts to resolve this issue. We believe that the approach contained in S. 2532 is an important step toward providing savings banks with a true

Federal charter alternative. Because the act would terminate the existing indemnification agreement; however, those savings banks which desire, for very good reason, to operate solely under the jurisdiction of the Federal Home Loan Bank and obtain FSLIC insurance, will be disadvantaged.

The preferable approach is to combine the provisions contained in S. 2532 with an expanded indemnification clause along the lines of S. 1810. This will provide an opportunity for growth through voluntary thrift institution mergers, as well as a practical Federal charter alternative for savings banks.

With regard to the other provisions contained in S. 2532, we recognize the need to provide the regulators with additional flexibility to deal with troubled institutions.

We believe that the FDIC should have authority parallel to that of the FSLIC, so that similarly situated institutions will be eligible for similar treatment regardless of their regulator. Accordingly, we support the expanded authority for the FDIC to provide direct financial assistance to an institution under section 13(c) of its act, since this would provide for parity between the two insuring agencies in assisting troubled institutions within their jurisdictions.

With respect to extraordinary mergers, S. 2532 does not contain a priority list for the FDIC to follow, even though such a list would be applicable to the Federal Home Loan Bank Board in dealing with savings and loan associations. NAMSB supports the concept of statutory priority standards for extraordinary mergers. We see no logical reason for distinguishing between savings banks and savings and loan associations on this point.

While capital assistance and increased flexibility for the Federal agencies are imperative in meeting immediate problems, broadened and more flexible asset and liability powers are vital, if we are to avert recurring thrift industry crises in future high interest rate periods. For two decades, the savings bank industry has urged that asset and liability powers of thrifts be broadened. We urge again that broadened powers be a part of the congressional response to the thrift crisis. Let me say without any hesitation, that if the Congress equivocates on the powers issue, the whole thrift problem will be back to haunt you in a very short time.

In conclusion, Mr. Chairman, S. 2521 and S. 2532 and the broadened powers legislation, represent substantial progress toward development of a comprehensive program to address the thrift industry problem. We welcome the opportunity to work with the committee in its consideration of this vitally needed program.

[The complete statement follows:]

Statement
of the
National Association of Mutual Savings Banks
on
S. 2531, The Capital Assistance Act of 1982
and
S. 2532, The Deposit Insurance Flexibility Act
before the
Committee on Banking, Housing and Urban Affairs
United States Senate
May 27, 1982

Mr. Chairman and members of the Committee, my name is Herbert W. Grey. I am Chairman of the National Association of Mutual Savings Banks and Chairman of the Mutual Bank For Savings in Boston, Massachusetts. The National Association represents the nation's 435 savings banks. Located in 16 states, savings banks are basically community-oriented financial institutions. In the areas where they are most heavily concentrated, savings banks are the largest holders of consumer savings as well as the dominant mortgage lenders among the various types of depository institutions. The industry's assets total $175 billion.

I appreciate the opportunity to present the views of the savings bank industry on S. 2531, the Capital Assistance Act of 1982, and S. 2532, the Deposit Insurance Flexibility Act. The latter is a revised version of the so-called "regulators' bill" which has already passed the House as a separate bill (H. R. 4603) and was included as part of S. 1720. In addition to commenting on the issues raised by S. 2531 and S. 2532, I would also like to reiterate the savings bank industry's strong support for the broadened asset and liability powers for thrifts contained in Title I of S. 1720.

Summary of Savings Bank Industry Position

Mr. Chairman, the National Association heartily applauds the development of proposals for dealing with the rapidly deteriorating condition of the

nation's savings banks and savings and loan associations. Savings banks have been severely impacted by unprecedented disintermediation and bottom-line losses in a destructive interest rate environment. As a result, we have urged the development and implementation of a comprehensive federal program to address the thrift institutions problem.

The legislative proposals embodied in S. 2531 and S. 2532, together with the broadened powers contained in S. 1720, would, in large measure, be such a program.

In our view, the present regulatory policies are not adequate to deal with the thrift industry problem. To date, the primary means of addressing the unprecedented difficulties facing savings banks and savings and loans has been forced mergers. This amounts to punishing an institution for conditions which are all-too-often completely beyond its control. In addition, this approach raises three major public policy concerns:

First, forced mergers reshape the financial structure by regulatory fiat, eliminating many community-oriented thrift institutions, and effectively "nationalizing" a major segment of the thrift industry;

Second, the adverse publicity accompanying a continuous wave of forced mergers will aggravate the erosion of public confidence in the nation's financial system; and

Third, primary reliance on forced mergers will become increasingly expensive, and could exhaust the resources of the deposit insurance agencies and deepen the federal budget deficit. In this vein, it should be noted that since November, 1981, the FDIC has expended approximately $1.8 billion dollars to arrange the mergers of nine mutual savings banks.

In expressing our concerns regarding forced mergers, however, I do want to state that the National Association has always supported market-determined mergers because of the great benefits they can offer, not only to

the institutions involved, but to the communities they serve. These mergers are likely to accelerate in the years ahead. But this is a far cry from mergers ordained by federal regulators. When the federal deposit insurance funds were established in the 1930's, it was never the intent of Congress that the administrators of these funds would also assume the awesome responsibility of restructuring the industry in which the deposits were insured. Yet this is precisely what is happening. At the very least, it should be our elected federal and state officials who make decisions affecting the shape of the nation's financial structure.

By providing capital assistance to troubled thrift institutions, S. 2531 would alleviate the pressure on the federal regulators to arrange supervisory mergers. Moreover, it should be noted that S. 2531 would not involve any budgetary expenditures and thus would be entirely consistent with efforts to reduce the federal deficit. As discussed more fully later, however, we have serious reservations as to the adequacy of the assistance formula. Furthermore, we have serious reservations regarding the provisions authorizing the regulators to "condition" the receipt of capital assistance in ways that could potentially nullify the intent of this legislation.

The National Association also wants to express its support for S. 2532. The major change in this version of the regulators' bill is in its treatment of the insurance status of savings banks converting to federal charter. The new approach embodied in S. 2532 would grant a savings bank the option of retaining FDIC insurance upon conversion to a federal charter under the FHLBB. We believe this represents a constructive step forward in resolving the so-called "indemnification" problem that has, for almost a year now, resulted in a <u>de facto</u> moratorium on conversions by savings banks to a federal charter.

The other important aspect of S. 2532 is the expanded authority for the FDIC to provide direct financial assistance to an institution under Section 13(c) of the Act and, in this regard, S. 2532 is unchanged from the version of the regulators' bill which passed the House in October 1981. NAMSB strongly supports this expansion of 13(c) inasmuch as it would provide for parity between FDIC and FSLIC in assisting troubled institutions within their jurisdiction.

While federal assistance along the lines provided in S. 2532 and increased flexibility for the federal agencies are imperative in meeting immediate problems, a restructuring of the thrift industry is essential to assure the industry's long-run competitive viability. Action must be taken now to authorize broadened and more flexible asset and liability powers for thrift institutions. Only with expanded asset and liability authority will the thrift industry be able to pay market rates to savers, compete in a deregulated environment with depository and nondepository institutions, and help generate the savings needed for full economic recovery. Only with broadened powers will it be possible to avert recurring crises in the thrift industry in future high interest rate periods. For two decades, NAMSB has strongly urged that the asset and liability powers of thrift institutions be broadened. We urge again that broadened powers be an integral part of the Congressional response to the thrift crisis.

S. 2531, The Capital Assistance Act of 1982

S. 2531 would temporarily alleviate the short-term problems of thrift institutions by slowing down the erosion of the net worth or surplus accounts of savings banks and savings and loan associations. Under the capital assistance plan, the FSLIC and the FDIC would be authorized to issue promissory notes in exchange for capital certificates issued by depository institutions, thereby increasing their net worth or capital accounts. For institutions with

net worth equal to 2-3 percent of assets, the assistance would amount to 30 percent of their actual losses. For institutions with 1-2 percent net worth, assistance would be 40 percent of actual losses, and for those with 0-1 percent net worth, the assistance would equal 50 percent.

At the outset, we note that S. 2531 incorporates several important improvements from similar plans that have been suggested in the past. Reliance upon an institution's actual losses rather than a comparison with a so-called peer group is a particularly useful change. Certainly, it would be unfair and meaningless to base assistance available to an individual institution on average loss rates, given the diversity of legal and economic environments in which financial institutions operate.

We are also very pleased that the bill incorporates a provision that would have the effect of preempting certain types of state and local taxes for institutions which have capital instruments outstanding under this Act. Some states and localities levy a franchise tax on mutual savings banks based solely on the volume of deposits, or on their gross income, with the tax being imposed regardless of whether or not the bank is making or losing money. Imposing a tax on an institution which has no net income is illogical and inequitable, and we are pleased that the preemption is included in the bill.

Although the savings bank industry strongly supports the thrust and purpose of the Capital Assistance Act, we have serious reservations as to the adequacy of the assistance formula provided in the bill. Our analysis of the proposal concludes that in an environment of continued high interest rates, the 50-40-30 plan would slow down, but hardly halt, net worth erosion and the resulting process of forced mergers. Under the plan, the institutions would not receive sufficient assistance to cover their losses fully, even on a temporary basis. The life expectancy of assisted institutions would be

extended somewhat, but the principal beneficiary would be the regulators since they would have more time to arrange mergers.

This can be illustrated by assuming that 1981 loss rates continue in 1982 and 1983. Since actual loss rates for 1982 are expected to exceed 1981 levels, this scenario must be considered "optimistic." Assuming S. 2531 goes into effect on June 30, 1982, a substantial number of savings banks would be "saved" for the time being, while others would still exhaust net worth or reach net worth levels that would probably result in mergers forced by FDIC. Under the Scenario I, by the end of 1983, 17 savings banks with $22 billion in assets (12 percent of industry assets) would have net worth ratios below 1 percent, even with S. 2531. The chief impact would be that some institutions, which would otherwise exhaust net worth entirely, would be marginally above zero.

Projected Net Worth Positions of Savings Banks, End of 1983
Scenario I: Losses Continue at 1981 Rate

Net Worth to assets (%)	Negative	0-1%	1-2%	2-3%
Without assistance				
Number of banks	16	5	12	25
Assets (billions)	$21	$4	$12	$18
% of industry assets	12%	2%	7%	10%
With S. 2531				
Number of banks	2	15	10	31
Assets (billions)	$1	$21	$13	$20
% of industry assets	*	12%	8%	11%

Broadly comparable results appear under the more stringent Scenario II, which assumes that losses will be 70 per cent above 1981 in a climate of increased interest rates. Even with S. 2531, 18 banks with $22 billion in assets (13 percent of industry assets) would completely exhaust net worth by the end of 1983. Another 12 banks with $16 billion (9 percent of industry assets) would have net worth between zero and 1 percent and would be obvious merger candidates under present FDIC policies.

Projected Net Worth Positions of Savings Banks, End of 1983
Scenario II: Losses Are at 70% Above 1981 Rate

Net Worth to assets (%)	Negative	0-1%	1-2%	2-3%
Without assistance				
Number of banks	28	19	16	30
Assets (billions)	$35	$13	$6	$17
% of industry assets	20%	7%	3%	10%
With S. 2531				
Number of banks	18	12	29	34
Assets (billions)	$22	$16	$15	$18
% of industry assets	13%	9%	8%	10%

In sum, the capital assistance plan would be helpful to some institutions. It would not, however, halt the regulatory process of forced mergers. As indicated above, the savings bank industry has a philosophical difference with the regulators on the issue of forced mergers. We believe that our nation has been well served by a system of community-oriented financial institutions and do not believe that this system should be abandoned without full public debate on the issue. Accordingly, we believe that the bill should be revised to direct the agencies to provide a higher level of support to troubled institutions.

Specifically, we urge the following formula:

1. Institutions with net worth below 2 per cent of assets would receive assistance in an amount sufficient to maintain net worth at 2 per cent. It should be noted that this would still leave net worth positions of these institutions below the minimum 3 per cent net worth standard of the Federal Home Loan Bank Board.

2. Institutions with net worth between 2 and 3 per cent of assets would receive assistance equal to some percentage (less than 100 per cent) of their actual losses.

3. Institutions with net worth above 3 per cent could receive assistance, at the sole discretion of the federal regulators.

As S. 2531 is presently drafted, the agencies at their discretion, could provide assistance at levels above the 50-40-30 percentage levels. Our concern is that, unless the legislation is revised, the 50-40-30 formula would be the operative provision. As a result, the process of forced consolidation would continue.

The intent of our recommendations is to stabilize net worth positions at a minimum level until interest rates decline and thrift institution profitability is restored. This would result in a halt, or at least a pause, in the process of forced consolidation of the thrift industry. As indicated earlier in this statement, the issue of thrift industry consolidation should be determined by the Congress, after careful deliberation. It should not be determined solely by the regulatory agencies.

The National Association also objects to the provisions in the bill relative to the regulators' "conditioning" the receipt of federal assistance. Under the bill, the regulators would have explicit authority to condition assistance upon a number of management actions, including execution and implementation of resolutions and agreements to merge or reorganize. The problems confronting the thrifts stem, in large part, from government policy. Federal housing policy has required thrifts to invest heavily in fixed-rate, long-term mortgages. In recent years, federal economic policy has failed to restrain inflationary forces and this has resulted in the climate of sharply higher and volatile interest rates. Thrift management did not seek, nor could it anticipate, the hostile economic climate that has characterized recent years.

Accordingly, we believe that the price for federal assistance should not be forced mergers and reorganizations. We believe that the legislation

should be amended to impose reasonable limits on the power of the federal regulators to insist on agreements by management to merge or consolidate as a precondition of receiving net worth assistance.

It should also be noted that S. 2531 does not provide a mechanism whereby capital assistance could be made available to non-federally insured savings banks. Currently, there are approximately 100 savings banks, all of which are located in Massachusetts, the deposits of which are not insured by the FDIC. Total assets of these institutions are almost $13 billion and represent approximately 50 percent of the total assets of all Massachusetts savings banks.

The difficulties faced by these state-insured institutions are the same as those faced by their federally-insured brethren. Their problems stem, in large part, from federal government policy. Accordingly, we believe it appropriate for the Congress to develop a procedure whereby assistance could be extended to non-federally insured institutions. For example, the state insurance funds could be required to enter into an agreement to fully indemnify the federal insurance agencies administering the capital assistance program for any losses realized as a consequence of helping a state-insured institution.

S. 2532, The Deposit Insurance Flexibility Act

NAMSB continues to support enactment of legislation to increase the flexibility of the federal regulatory agencies in dealing with troubled institutions. In addition, we have for a number of months been seeking action to resolve the existing impasse between the FDIC and the FHLBB in the case of conversion of an FDIC-insured, state-chartered savings bank into an FSLIC-insured, federally-chartered savings bank. One approach to accomplishing this

is embodied in S. 1810 and we are particularly indebted to Senators D'Amato, Heinz and Proxmire who have cosponsored this legislation. Chairman Garn has also been actively involved in the efforts to resolve this issue.

No federal savings bank charters have been granted since October 1981, and there now exists a backlog of approximately 15 applications. The major cause of the moratorium has been a dispute between the FDIC and the FSLIC over the extent of indemnification against losses of FSLIC by the FDIC in the event that a federal savings bank should require any type of payout. Because the agreement reached in May of 1979, pursuant to the original federal charter legislation, covers only "credit" losses and not "market" losses caused by high interest rates, the agreement is unacceptable to the FSLIC. As a result, the Federal Home Loan Bank Board has refused to permit savings banks to convert from state to federal charter.

The FDIC and the FHLBB have recently reached agreement on a "compromise" legislative solution to the indemnification problem. S. 2531 incorporates this approach by permitting state savings banks converting to federal charter to retain their FDIC insurance. The converted bank would be subject to regulation and examination by the Federal Home Loan Bank Board. The bank's relationship with the FDIC would be parallel to that of a national bank. As in the case of national banks, the FDIC would, however, have the authority to pass on any merger between a federally-chartered, FDIC-insured savings bank with a nonFDIC-insured institution. The latter would, of course, include savings and loan associations.

In addition, the existing statutory indemnification formula would be terminated. As a result, a savings bank could convert to FSLIC insurance, but FSLIC would not receive indemnification from the FDIC for any conversions subsequent to the effective date of the Act.

We believe that the approach contained in S. 2532 is an important and constructive step towards providing savings banks with a true federal charter alternative. Under these provisions, savings banks which want to operate under a charter granted by the Federal Home Loan Bank Board would, in fact, be able to obtain a federal charter.

However, those savings banks which desire to operate solely under the jurisdiction of the FHLBB and obtain FSLIC insurance would be disadvantaged since -- without indemnification from the FDIC -- FSLIC would likely be reluctant to approve applications for deposit insurance. As indicated earlier, our industry strongly supports market-mandated mergers. However, the clear preference of the Bank Board is to permit mergers only between FSLIC-insured institutions. This preference, coupled with the reluctance of the FDIC to permit an FDIC-insured institution to merge with FSLIC-insured savings and loan associations, means that, realistically, the opportunities for growth through merger of a federally-chartered, FDIC-insured savings bank would be severely curtailed.

Accordingly, we believe that the preferable approach is to combine the provisions contained in S. 2532 with an expanded indemnification clause along the lines of S. 1810. This would provide an opportunity for growth through voluntary thrift institution mergers as well as fulfill the intent of Congress to provide savings banks with a true federal charter alternative.

With regard to the other changes contained in the revised regulators' bill we would offer the following comments:

Assisted Mergers. Under the House-passed version of the regulators' bill, the FDIC could provide financial assistance to any bank or bank holding company acting as the acquirer of an insured bank in distress. S. 2532 would expand this authority to include the grant of assistance to "any company"

acting as the acquiring entity. We question whether the need to include nonbank financial, or even nonfinancial, corporations within the range of permissible acquirers can be justified at this time.

Constitutional Exemption. The authority of the regulators to require an institution to convert to stock form in order to facilitate a merger could be exercised under S. 2532 without regard to the constitution of any state. This change represents an important technical improvement over previous drafting which was limited simply to "the laws" of any state.

Extraordinary Acquisitions. The revised regulators' bill restores that section authorizing the FDIC to arrange interstate and interindustry mergers to its original form, i.e., applicable to savings banks as well as commercial banks. An amendment to the House bill had limited this section strictly to savings banks. In addition, the threshold for triggering such authority has been lowered by S. 2532 to cover any insured bank with total assets of $500 million or more, as opposed the $2 billion figure utilized in all prior versions of the regulators' bill. Including commercial banks within the scope of this provision would improve the legislation from the standpoint of providing reciprocity between types of institutions, but we question whether the case has been made for reducing the threshold for cross-industry mergers from $2 billion to $500 million.

We note, however, that S. 2532 deletes another important House-passed amendment which established a priority list for the FDIC to follow in arranging "extraordinary" mergers. The first priority was for such mergers to be between institutions of the same type in the same state; the same type out of state; different types within a state; and, finally, different types on an interstate basis. At the same time, S. 2532 would retain the comparable priority test for the FHLBB to follow with respect to institutions under its

jurisdiction. NAMSB supports the concept of statutory priority standards, and there would certainly appear to be no logical reason for distinguishing between savings banks and savings and loan associations on this point.

Broadened Powers

The National Association has supported broadened powers for thrift institutions for two decades. We fully support the expanded asset and liability powers contained in S. 1720. Moreover, we subscribe to the principle that if commercial banks are to be permitted to compete on equal terms with thrift institutions for deposits, then thrift institutions must be able to compete on equal terms with commercial banks on the asset side of the balance sheet.

We very much appreciate the bipartisan leadership of this Committee in advocating expanded powers and believe that ultimately there should be no limitation on the ability of thrifts to compete with commercial banks. But given the present political realities and the relatively short time in which to enact legislation, we are willing to be flexible on the issue in order to permit a consensus to develop. In reviewing the sweeping changes proposed in S. 1720, the following emerge as absolutely critical to the long-term survival of savings banks:

Commercial Lending and Checking. Federal savings banks were authorized to make commercial loans up to 5% of assets in the Depository Institutions Deregulation and Monetary Control Act of 1980. The law also requires such loans be made only within the state where the bank is located or within 75 miles of the bank's home office. In addition, savings banks were authorized to accept corporate demand deposits in connection with a business, corporate or commercial loan relationship. An increase in lending authority, deletion of the geographic lending limits, and elimination of the restriction on checking account authority are absolutely essential at this time.

<u>Chartering Authority for Federal Thrifts</u>. The FHLBB should be authorized to charter federal savings banks <u>de novo</u> in all 50 states and also through the conversion of federal and state savings and loan associations. Any federal savings bank or federal savings and loan should be able to change its designation from a federal savings bank to a federal savings and loan association or the reverse. In addition, the current prohibition against the conversion of a federal mutual savings bank into a stock institution should be eliminated.

<u>Branching Authority for Federal Thrifts</u>. Existing law provides federal savings banks with the same general branching authority permitted state-chartered savings banks. However, federal savings banks are exempted from state-mandated numerical limitations and are allowed, in any case, to branch within their Standard Metropolitan Statistical Area, within their own county or within 35 miles of the home office, but only in the state of domicile. We believe that these restrictions on branching should be eliminated and federal savings banks should have parity in branching with federal savings and loan associations.

<u>Investment Authority</u>. The investment authority of federal savings banks should be updated. Under present law, a state-chartered savings bank converting to a federal charter may continue to carry on any activities it was engaged in on a specified date -- December 31, 1977. Such a converting institution is also authorized to retain or make any investment of a type it held on that date, except that its equity, corporate bond, and consumer loan investment may not exceed the average ratio of such investments to total assets for the five-year period immediately preceding the filing of an application for conversion. The December 31, 1977 cut off date is increasingly obsolete and there is no reason to hold a federal savings bank

organized now or in future years to the particular activities and investments which it happened to engage in as of December 31, 1977. Thus, the date should be changed to the date immediately prior to conversion and the five-year average limitation should be deleted.

Service Corporations. The authority to invest in service corporations should be increased from 3% to 10% of an institution's assets and the existing requirement that a portion of this authority should be used for community, inner-city and community development purposes should be deleted.

Bank Holding Company Powers. Federal savings banks should be able to carry on all activities authorized to bank holding companies, as the FHLBB defines such powers. Since federal savings banks are authorized to engage in what was once exclusively a commercial bank preserve, they should not be barred from the useful and profitable activities carried on through bank holding companies.

Conclusion

In conclusion, Mr. Chairman, the savings bank industry urges prompt Congressional action on a comprehensive thrift assistance package. We believe that such a package should include capital assistance, expanded authority for the regulatory agencies, and broadened powers for thrift institutions. We hope that this statement will be helpful to the Committee as it develops this very necessary legislation.

The CHAIRMAN. Thank you very much, Mr. Gray.
Mr. Coles?

STATEMENT OF JOHN E. COLES, PRESIDENT, PEOPLE'S SAVINGS & LOAN ASSOCIATION, HAMPTON, VA., ON BEHALF OF THE AMERICAN SAVINGS & LOAN LEAGUE

Mr. COLES. Mr. Chairman, Senator Brady, members of the committee. I'm John E. Coles, president of People's Savings and Loan Association of Hampton, Va. I am pleased to present to you the views of the American Savings and Loan League on S. 2531 and S. 2532, measures concerned with shoring up the net worth of mortgage-issuing depository institutions and providing for the orderly handling of problem cases.

Before proceeding with my testimony, I would like to state for the record that our membership, who are also members of the U.S. League of Savings Associations, concur with the testimony given by the U.S. League today. The purpose of my remarks will be to point out to the committee that minority S. & L.'s are unique and to stress that every effort should be made to preserve their minority character in the legislation that is eventually enacted to rescue the thrift industry.

The American Savings and Loan League members are savings associations owned or controlled by Blacks, Hispanics, and Asian-Americans. Our associations are small and young. Most of us have less than $100 million in assets, and only one-half have been in existence for more than 10 years. In spite of our small size, however, these institutions have become an integral part of minority neighborhoods throughout the country.

Collectively, the 85 minority S. & L.'s represent over $2.6 billion in assets. These assets are for the most part mortgages we have been able to make for minority homeownership. We provide mortgage financing for inner city homeowners. We help alleviate urban blight by investing in minority economic development activities; and by the mere fact of our existence, we serve as role models to boost morale of other memers of the minority business community.

Minority S. & L.'s have some distinct problems of their own. They serve a narrower market. In the marketplace we are disadvantaged by size. The disposable incomes of our depositors are less, causing them to have lower balances and more active accounts that are costly to maintain. Mortgage loans are not paid off as fast in minority S. & L.'s. Further, our size does not allow us to benefit fully from the new investment powers recently granted to the savings and loan industry. In contrast to older S. & L.'s, one-half of our member institutions have not had sufficient time in business to accumulate adequate net worth and develop a broad customer base. This situation has been worsened by several recessions since 1974 and current economic conditions.

MINORITY S. & L.'S SERIOUSLY THREATENED

Today, the survival of minority S. & L.'s is seriously threatened, since the solution to low net worth usually is merger with a larger, stronger, but nonminority institution. Over the past year and a half, seven American League members have been merged out of

existence, because of inadequate net worth. Of the four mergers that have occurred since January, there was only one merger between two minority S. & L.'s. The others were with larger, non-minority S. & L.'s, one even being an interstate merger with the largest S. & L. in the country.

We have estimated that if current economic conditions continue, approximately 40 percent of the minority S. & L.'s in the United States will be candidates for merger. Without some form of assistance to shore up the net worth of the remaining associations and to give them an opportunity to restructure themselves, the consequences can be disastrous for minority S. & L.'s and the communities they serve. As the only financial institution in many inner city neighborhoods, minority S. & L.'s have directed their efforts, however small, toward promoting thrift and homeownership among minorities and slowing the process of urban decay.

These institutions have also set an example which may convince the younger generation of Blacks, Hispanics and Asian-Americans that the American drean can work for them too.

Although the oldest minority S. & L. was formed in 1888, the encouragement of minority owned and managed S. & L.'s is of fairly recent vintage. It all began in 1969, when the Nixon administration came into office and determined to solve the Nation's racial problems. Executive Orders 11458 dated March 5, 1969 and 11625, dated October 15, 1971, constitute a landmark in the history of minority business, for they established the guidelines for developing and coordinating a national program for minority business enterprise. The intent was to rectify the uneven distribution of income and social status by assisting minority capitalism and aiding the entry of ethnic minorities into the mainstream of the American economy.

Pursuant to these orders, the Office of Minority Business Enterprise was established in the Department of Commerce to promote a wide range of minority business enterprise activities. Within the Federal Home Loan Bank Board, a Minority Associations Development Division was established for the purpose of coordinating and implementing a program to encourage the growth, expansion, safety and soundness of minority owned and managed S. & L.'s. As a result of these initiatives, the number of minority S. & L.'s doubled from 1969 to the present. In rendering assistance to these S. & L.'s, a program of management and technical assistance to newly formed minority S. & L.'s was undertaken. Those in difficulties were afforded rehabilitation assistance under assistance agreements with FSLIC.

Finally, a Savings and Loan Minority Business Enterprise Small Business Investment Company was authorized by Congress in 1979. The MESBIC was to be capitalized with $5 million invested by the 12 Federal Home Loan Bank districts.

Because of the dire circumstances of the entire industry, none of these programs has been fully implemented, and the foothold that minority S. & L.'s have gained is rapidly eroding.

You can rest assured, Mr. Chairman, and members of the committee that once a minority S. & L. goes out of business or is merged so that its ethnic identity is lost, that when conditions improve, you will not see another one formed. There is simply not the public confidence in these S. & L.'s that we see in the wider econo-

my, hence, the need to take affirmative steps to assure that these institutions maintain their distinct identity and are not merged into oblivion. I might add that once S. & L.'s in close localities are merged into a nonminority shop, you will find that the other minority S. & L.'s in the area will be adversely affected.

We recognize that in every instance it is not possible to merge a minority S. & L. with another one, simply because often there is none available or none strong enough to merge without assistance. We also recognize that some shops cannot be saved and should be allowed to merge for the protection of the depositors; that there is a need to cut expenses to the greatest expense possible; and that temporary net worth assistance is worthless without new powers and a corresponding lowering of interest rates and some means of allowing a restructuring of the thrift asset portfolios.

We would support all efforts to shore up the industry and the public's confidence in its insured financial institutions. At the same time, however, we do not wish to see the baby thrown out with the bath water or to see a 10-year-old commitment to the expansion of minority business enterprise in the S. & L. industry be abandoned in the effort to solve the problems of the industry as a whole.

What we propose is a merger policy that takes into account all reasonable alternatives to merger prior to merging a minority S. & L. out of existence, and a continuation of the program within the Federal Home Loan Bank, designed to strengthen the management and operations of newly formed and fledgling minority S. & L.'s.

I appreciate your attention and will be happy to respond to your questions.

[The complete statement follows:]

STATEMENT OF JOHN E. COLES
PRESIDENT
PEOPLE'S SAVINGS AND LOAN ASSOCIATION
HAMPTON, VIRGINIA

ON BEHALF OF

THE AMERICAN SAVINGS AND LOAN LEAGUE, INC.
MAY 27, 1982

Mr. Chairman and Members of the Committee, I am John E. Coles, President of People's Savings and Loan Association of Hampton, Virginia. I am pleased to present to you the views of the American Savings and Loan League on S. 2531 and S. 2532, measures concerned with shoring up the net worths of mortgage-issuing depository institutions and providing for the orderly handling of problem cases.

Before proceeding with my testimony, I would like to state for the record that our membership, who are also members of the U. S. League of Savings Associations, concur with testimony given by the U. S. League today. The purpose of my remarks will be to point out to the Committee that minority S&Ls are unique and to stress that every effort should be made to preserve their minority character in the legislation that eventually is enacted to rescue the thrift industry.

The ASLL's members are savings associations owned or controlled by Blacks, Hispanics, and Asian-Americans. Our associations are small and young; most of us have less than $100 million in assets and only one-half have been in existence for more than 10 years. In spite of our small size, however, our institutions have become an integral part of minority neighborhoods throughout the country. Collectively the 85 minority S&Ls represent over $2.6 billion in assets. These assets are for the most part mortgages

we have been able to make for minority homeownership. We provide mortgage financing for inner-city homeowners. We help alleviate urban blight by investing in minority economic development activities; and by the mere fact of our existence, we serve as role models to boost the morale of other members of the minority business community.

Minority S&Ls have some distinct problems of their own. They serve a narrower market. In the marketplace, we are disadvantaged by size; the disposable incomes of our depositors are less, causing them to have lower balances and more active accounts that are costly for us to maintain. Mortgage loans are not paid off as fast in minority S&Ls. Further, our size does not allow us to benefit fully from the new investment powers recently granted to the savings and loan industry. In contrast to older S&Ls, one-half of our member institutions have not had sufficient time in business to accumulate adequate net worth and develop a broad customer base. This situation has been exacerbated by several recessions since 1974 and current economic conditions.

Today, the survival of minority S&Ls is seriously threatened, since the solution to low net worth usually is merger with a larger, stronger, but non-minority institution. Over the past year and a half, 7 American League members have been merged out of existence because of inadequate net worth. Of the 4 mergers that have occured since January, there was only one merger between two minority S&Ls; the others were with larger, non-minority S&Ls, one even being an interstate merger with the largest S&L in the country. We have estimated that if current economic conditions continue, approximately 40 percent of the minority S&Ls in the United States will be candidates for merger.

Without some form of assistance to shore up the net worth of the remaining associations and to give them an opportunity to restructure themselves, the consequences can be disastrous for minority S&Ls and the communities they serve. As the only financial institution in many inner city neighborhoods, minority S&Ls have directed their efforts, however small, toward promoting thrift and homeownership among minorities and slowing the process of urban decay. These institutions have also set an example which may convince the younger generation of Blacks, Hispanics and Asian-Americans that the American dream can work for them too.

Although the oldest minority S&L was formed in 1888, the encouragement of minority-owned and managed S&Ls is of fairly recent vintage. It all began in 1969 when the Nixon Administration came into office determined to solve the nation's racial problems. Executive Orders 11458 (March 5, 1969) and 11625 (October 13, 1971) constitute a landmark in the history of minority business, for they established the guidelines for developing and coordinating a national program for minority business enterprise. The intent was to rectify the uneven distribution of income and social status by assisting minority capitalism and aiding the entry of ethnic minorities into the mainstream of the American economy.

Pursuant to these orders, the Office of Minority Business Enterprise was established in the Department of Commerce to promote a wide range of minority business enterprise activities. Within the Federal Home Loan Bank Board, a Minority Associations Development Division was established for the purpose of coordinating and implementing a program to encourage the growth, expansion, safety and soundness of minority-owned and managed S&Ls.

As a result of these initiatives, the number of minority S&Ls doubled from 1969 to the present.

In rendering assistance to these S&Ls, a program of management and technical assistance to newly formed minority S&Ls was undertaken; those in difficulties were afforded rehabilitation assistance under assistance agreements with FSLIC. Finally, a Savings and Loan Minority Business Enterprise Small Business Investment Company (S&L MESBIC) was authorized by Congress in 1979. The MESBIC was to be capitalized with $5 million invested by the 12 Federal Home Loan District Banks.

Because of the dire circumstances of the entire industry, none of these programs has been fully implemented, and the foothold that minority S&Ls have gained is rapidly eroding. You can rest assured, Mr. Chairman and Members of the Committee, that once a minority S&L goes out of business or is merged so that its ethnic identity is lost, that when conditions improve, you will not see another one formed. There is simply not the public confidence in these S&Ls that we see in the wider economy. Hence, the need to take affirmative steps to assure that these institutions maintain their distinct identity and are not merged into oblivion.

We recognize that in every instance it is not possible to merge a minority S&L with another one, simply because often there is none available or none strong enough to merge without assistance. We also recognize that some shops cannot be saved, and should be allowed to merge for the protection of depositors; that there is need to cut expenses to the greatest extent possible; and that temporary net worth assistance is worthless without new powers and a corresponding lowering of interest rates, and some means of allowing a restructuring of the thrift asset portfolios. We would support

all efforts to shore up the industry and the public's confidence in its insured financial institutions.

At the same time, however, we do not wish the baby to be thrown out with the bathwater, or to see a 10 year old commitment to the expansion of minority business enterprise in the S&L industry be abandoned in the effort to solve the problems of the industry as a whole. What we propose is a merger policy that takes into account all reasonable alternatives to merger prior to merging a minority S&L out of existence, and the continuation of the program within the Federal Home Loan Bank Board designed to strengthen the operations, management and viability of newly formed and fledgling minority S&Ls.

Mr. Chairman, we would like to submit a copy of the American League's testimony on H.R. 5568 for the record. I appreciate your attention and will be happy to respond to your questions.

Statement of William B. Muse, Jr., on Behalf of the American Savings and Loan League, Inc.
March 18, 1982

Mr. Chairman and Members of the Committee, I am William B. Muse, President of Imperial S&LA of Martinsville, Virginia. I am pleased to present to you the views of the American Savings and Loan League on H.R. 5568, a measure concerned with shoring the net worth of mortgage issuing depository institutions above the two percent mark.

The ASLL's members are savings associations owned or controlled by Blacks, Hispanics, and Asian Americans. Our associations are small and young; most of [illegible] have less than $100 million in assets and only one half have been in existence for [illegible] than 10 years. In spite of our small size, however, our institutions have become an integral part of minority neighborhoods throughout the country. Collectively we represent over $2.8 billion in assets. These assets are for the most part mortgages we have been able to make to further [illegible] home-ownership. We provide mortgage financing for inner-city homeowners. We help to alleviate urban blight by investing in minority economic development activities, and by the [illegible] fact of our existence we serve as role models to boost the morale of other members of the minority business community.

Presently, economic forces combined with the total insensitivity of the Reagan Administration are threatening the survival of minority thrift institutions. Some of the problems of minority S&Ls are common to the entire thrift industry. The major problem [illegible] have in common is declining net worth due to the high cost of short term borrowing. According to the Federal Home [illegible] Bank Board, the national average [illegible] cost of funds for FSLIC insured associations for the [illegible] months ending June 30, 1981 was 10.31 percent. The portfolio yield for the same period [illegible] percent. This represents a negative spread of [illegible] percent. Statistics for the second half of [illegible] show that the negative spread has increased. Accordingly out of 79 minority S&Ls, [illegible] posted net operating losses for the year ranging from $1,[illegible]32 to $1,950,394. We were able to absorb last year's losses by [illegible] accumulated surplus. However, should the negative spread continue to erode the net worth of the industry, many S&Ls soon will not be able to maintain the required statutory reserves. [illegible] Surely the Committee knows of the number of S&Ls that are projected to disappear if current conditions continue.

Minority S&Ls have some distinct problems of their own. In the marketplace we are disadvantaged by size. The disposable incomes of our depositors are less, causing them to have lower balances and more active accounts that [illegible] costly for us to maintain. Further, our size does not allow us to benefit fully from the new investment powers recently granted to the savings and loan industry. In contrast to older S&Ls, one half of our member institutions have not had sufficient time to accumulate adequate net worth and develop a broad customer base. The situation has been exacerbated by several recessions since 1974 and current economic conditions. Today, the survival of minority S&Ls is seriously threatened, since the solution for low net worth usually is merger with a larger, stronger, but non-minority institution. Over the past year and [illegible] half seven American League members have been merged out of existence because of inadequate net worth. Without some form of assistance to shore up the net worth of the [illegible] associations, we can be sure to see many more mergers with disastrous consequences for minority S&Ls and the communities they were chartered to serve. Without doubt, their loss will be felt by their communities, as minority S&Ls are frequently the only financial presence in minority neighborhoods. Their efforts, however small, have been directed toward promoting homeownership among minorities and toward slowing the process of urban decay. For years, they had been the only consistent mortgage lenders in "red-lined" inner-city areas. Finally, these minority institutions have set an example which may convince the younger generation of Blacks, Hispanics and Asian-Americans that the American dream can work for them too.

Today, however, the situation is sufficiently serious to warrant concern that the very phenomenon of minority savings and loan associations is facing extinction.

The St Germain bill will help maintain the strength and viability of minority S&Ls, and help us weather the current economic storm. It is a timely measure for the public confidence in the savings and loan industry is [illegible]. Articles with provocative titles such as, "How Safe Are Your Savings?" appear in the press almost daily, [illegible] depositors to worry about the viability [illegible] the thrift industry. The edifice of the banking system, painstakingly built on the public confidence in the aftermath of the great [illegible] on banks in the early Thirties, may crumble unless the authorities evince strong commitments to back up the thrift industry. The repercussions will definitely spread into the banking industry, and the consequences for the economy as a whole will doubtless be serious.

We support the Home Mortgage Capital Stability Act because it is a timely remedy for the thrift industry as a whole. Moreover, [illegible] have [illegible] particular desire to see the bill pass, for the assistance is not partial to big associations, but is committed to save any viable mortgage-lending depository institution regardless of its size. This would assure that the standard of fairness is maintained and would have the added benefit of preserving the separate identity of the minority S&L. Whether governmental assistance will come in the form of [illegible] capital stability fund, net worth guarantee, or some combination of the two, it will be a long overdue measure to relieve the burdens on our industry. Therefore, the American Savings and Loan League supports the proposal and would urge its speedy enactment.

The CHAIRMAN. Thank you very much, Mr. Coles.

Gentlemen, before I ask the question, let me say that just in the last week or 10 days there has been an intense campaign started, because of the fact that I said I would like to not only pass the capital assistance and regulations bills, but pass parts of S. 1720 with them, to separate those issues. It's not a new game. It's used constantly to say OK, go ahead and do the regulators bill, and so on, but put off any parts of S. 1720 until next year. Next year we'll figure out something else to do to block it.

How do you feel about that? Just let's forget it. Let's let Sears and Merrill Lynch roll on and don't worry about it. Just put the Band-Aid on this year and we'll worry about the future in the future.

Mr. Brooks?

Mr. BROOKS. Mr. Chairman, I would hope, of course, nothing would be done to hold up the capital assistance. It's been said many, many times it's a question of survival to get us from here to the point that when the powers come on line we can use them. And we need to have started that a good long time ago, so it would appear to me that if this bill and the powers bill could move together it would be highly desirable. There's no question about it. We need them both to move fast. That would be our view.

We need to get started on these powers. In my shop, even if I could start today, it's going to be a good, long while before the powers begin to affect my profitability. So I would like to see them both move expeditiously.

Mr. O'BRIEN. I would not only underscore Mr. Brooks' statements, but say that in many respects the powers bill is more important that the assistance bill. We have been talking about the powers bill for at least 9 months now, since your original introduction last October. An assistance bill without the powers bill would be a description for disaster, in my opinion.

Many of us need the short-term assistance to get us over this temporary hump, but the powers bill is absolutely essential. It is fundamental to the viability and the future health of this business.

The CHAIRMAN. Mr. Gray?

Mr. GRAY. I'd support without any hesitation what both of the witnesses have said. As I said earlier, if the Congress equivocates on thrift powers at this point in time, it is my considered judgment that the problem will be back to haunt you in a very, very short time. And to wait further at this point in time, would be a disaster.

The CHAIRMAN. Mr. Coles?

Mr. COLES. I would like to say that I support the gentleman who just preceded me. In addidtion, I hope an approach is taken that would not be a stop-gap measure that would help us to survive this year, and then next year we'll come back with something that's going to help us survive for another year or two. I would like to see an approach that's going to do something, that's going to completely alleviate the problems or give us something to work with, so that as an industry we can alleviate the problems that we are beset with.

COMPETITIVE ADVANTAGE DUE TO RESTRICTIONS

The CHAIRMAN. You know, I'm more frustrated and disappointed than upset about what is happening, because I have a difficult time understanding it. Four or 5 years ago I could understand it. I've made the statement many times in speeches all over this country and from this podium in introducing the bill, that I had no great pride of authorship, nor was I particularly concerned about the specifics of S. 1720. That is still the case. But trying to seek a consensus for an industry that includes independent bankers, the ABA, the U.S. Savings and Loan League, credit unions, all of the traditional depository institutions, as opposed to Merrill Lynch and the securities dealers, Sears, retailers, and $200 billion of money market funds. I don't know where I have ever looked at a situation where it seems so clear-cut that some new boys on the block had a very, very decided competitive advantage as a result of Government restrictions on their competitors.

And the more I look at it the more convinced I've become that is the case. And we have to, in some way, again without me attempting to dictate any specifics, address that inequity and invite the industry to get together and say, OK, how can we do that? What do we want to look like 5 years down the road, because even if we solve the current situation, in my opinion, even if the budget were balanced tomorrow and the interest rates dropped dramatically and we didn't need capital infusion, we didn't need a regulator's bill, all of that, nothing will change the way the financial community is currently operating. Money market funds will still be here; Sears will not get out of the business, they will be very aggressive. And I believe Mr. Telling's statement (from Sears Roebuck), when he says that there may not be 15,000 banks around in the future, he means it. He's going to operate out of every mail-order house, every place he can go, and that's reality.

I represent a small State. We don't have any big banks. Most of our banks are independent bankers. We've only got a million and a half people in the whole State, and as I've said many, many times, I would like to go back and have everybody neatly in their pigeon hole, all compartmentalized and doing whatever they're supposed to be doing. I'd like to have Sears just selling vacuum cleaners and furniture and soap and whatever else they do, when it was nice and neat. Everybody had their place.

With electronic funds transfer and high interest rates there is a revolution going on and there are certain segments of the industry whom I agree with insofar as I'd love to go back that far, but I don't know how to do it. I think we have to face reality.

Now we're getting this letter campaign, and this is only the start. I'm sure that it will come in in wheelbarrows of don't do anything. But I suppose what frustrates me more than anything else is blind opposition, rather than saying, "We disagree with this. We want you to change it."

There are parts of this capital infusion bill you don't like. You prefer the House bill. Fine. That is the legislative process and we will do something in a markup and we will eventually go to a conference, and Congressman Freddy St Germain and I will have to

resolve any differences. That is the way, it seems to me, you try to attack the problem rather than just saying, "We are opposed."

The nature of these letters I've been receiving is incredible. Just to quote, "We remain unalterably opposed to any change which would result in granting commercial banking powers to thrift institutions." We are profitable, we're doing just fine, the alligator hasn't started to chew on our tail yet, Sears hasn't touched us, so to hell with the guy in the thrift industry.

Now, if it were reversed, if you guys were fat cats and doing well and some other part of the industry was in trouble, I would be saying exactly the same thing to you. I don't understand one segment that is doing fine, that is unalterably opposed—in other words, "we're not willing to consider anything. We're not willing to debate it, we're not willing to suggest changes, we're not willing to compromise. We're unalterably opposed." And that is the general sense of every one of these letters. "We are just opposed. We've got our head stuck in the sand and we're not going to pull it out."

This is one that I would be embarrassed to write: "Don't grant commercial banking powers to thrift institutions. We already have too much competition," this was sent to me from an independent businessman in this country. This is like saying: "I don't care what it is. We have too much competition. We want Government to equalize that competition, to legislate my competitors out of business." And I'll bet you that man goes to chamber of commerce meetings and gives free enterprise speeches. [Laughter.]

The CHAIRMAN. I'm sorry, gentlemen, but I just don't understand blind opposition without a willingness to sit down and discuss a real problem which 5 years ago may not have been evident, but it certainly should be now. I don't know how many banks are going to be left. I thought I was starting on this a year ago to try and preserve a depository institution system that has served this country so well. It's amazing to me that when a politician takes a particular side, very definitely, no equivocation and says all these new boys on the block are doing something that is unfair and they're not giving me any flack. It's the existing industry that wants to live in 1950, I guess, or some other time.

MINIMIZE GOVERNMENT INTERFERENCE

Anyway, I'm supposed to be asking questions, not giving speeches. Mr. Brooks, in your testimony you stated that one of the objectives for a capital assistance program would be to minimize the need for direct Government agency interference, yet you also recommend that the program restore and maintain net worth at a particular level, in the case of the House at 2 percent. Do you feel there's any inconsistency in those two statements?

Mr. BROOKS. No, sir, Mr. Chairman, I do not. We have found out that in many cases when an association gets down, say, below 1 percent, that there are problems just due to that particular level, such as credit problems, borrowing problems from other than the Federal Home Loan Bank. There are even problems where these associations have loans for sale in order to restructure the asset side of their balance sheets. The purchasing associations, even other savings and loans, because the sellers have such low net

worth, the loan buyers are not sure they're going to be around to service the portfolio. And that places the loan sellers at a distinct advantage in that particular case.

I mean, we are involved in assistance. We're talking about a minimum of assistance, but we feel that some particular level, some minimum level is necessary. If it's not 2 percent, maybe it could be full coverage at 1 percent at this level, when it starts to get critical, at 1 percent and below, and then have the steps such as maybe 50 percent coverage between 1 and 2 percent; 30 percent, say, between 2 and 3 or any variations of that.

I'm told that by the end of 1983, if such a combination plan were followed, there would be $9 billion in ICC's issued, which would be slightly more than that net worth maintenance at 2 percent, with no partial coverage above that, which would be about $7.8 billion.

When you get down that low again there is a real problem just due to that level, and if you are still being drained down, not only do you have trouble with your accountants as a going concern, but you do have troubles, I'd say, trying to borrow money. You're trying to restructure, which your powers bill would enable us to do. It's causing all kinds of problems at that level.

The CHAIRMAN. Mr. O'Brien, if the FSLIC were actually to raise net worth levels and maintain them at any particular level, 2 percent, 1 percent, it doesn't make any difference, just the principle of a particular floor. What incentive is there, then, for the institutions to reduce their own operating costs to try and operate more efficiently?

Mr. O'BRIEN. Well, of course, we have already, as a business, taken extraordinary measures to cut costs and save every penny and nickel where we can. I understand there would be continuing incentives in this assistance package, whichever one passes. And by the way, the National League likes your bill better than Congressman St Germain's. But be that as it may, I see in both the suggestion of incentives. In fact, in your bill the regulators have extraordinary powers to, if you want to say, even dictate, rather than provide incentives to the day-to-day operations of the business. That's probably the biggest part of your bill that we don't like.

The CHAIRMAN. I didn't really expect you to. [Laughter.]

Mr. O'BRIEN. I mean, they can really run the institutions, so we think that's probably a little bit of overkill. But nevertheless, I don't think that's going to be a problem.

If I may comment on your earlier statement, I wouldn't let that pile of mail unduly disturb you, sir. It didn't look too thick. It's probably 100 or less letters, which is a small part of the banking community out there.

The CHAIRMAN. Oh, it doesn't disturb me from that standpoint. This is a small sample, but I am sure it will grow.

Mr. O'BRIEN. But we are meeting and have met several times, as you know, with the ABA—well, the nine big financial trade associations have met and are talking, and there is never going to be a true consensus. But myths are being debunked. We understand each other's problems. There is motion in that direction. I think we've made great progress, so please continue on your course, Mr. Chairman.

The CHAIRMAN. Oh, no, don't misunderstand my point. My point was exactly what you're saying. There has been great progress since last October, I mean, far more than I anticipated. My major point was the tone of letters that are coming in now are simply black and white. We are unalterably opposed. Oh, no, I never expect everybody to say this is great, we agree on every particular provision. No, that will never happen.

I was trying to say I wish these people would say we are willing to talk, we are willing to consider, we are willing to give you this here. You may want that back. But the tone of the letters coming in now is just don't do anything. It would be the same on the other side.

Mr. O'BRIEN. It's one-half percent of the business.

The CHAIRMAN. If you were saying we want 100 percent of all the powers for thrifts, that is the other side.

Mr. BROOKS. May I comment on that, Mr. Chairman? As you, I believe, mentioned in your opening statement yesterday morning, the U.S. League and the ABA have been meeting. I happened to be a part of those meetings, and I thought we came a long way. We really did. We got down to the bottom line and there are certain things that we just have to come over to the Hill to get resolved. But I was very optimistic and very much encouraged because of those meetings.

The CHAIRMAN. I have been, too, and that's why I made that statement yesterday and I repeated it again today, several times. I am very optimistic and I guess the fact that I've been stating that for the last 2 or 3 weeks is what is precipitating the opposition.

Mr. GRAY. I'd like to comment, if I might, on that. I think it's important to note that in at least one State, Massachusetts, comprehensive banking legislation for State-chartered institutions passed the third reading of the House a couple days ago and it's expected to pass the Senate today with the support of the Massachusetts bankers. This legislation will give thrift institutions all the powers—not just some of the powers—but all the powers of commercial banks over a stated period of time. State action can eventually be achieved, but if we don't do it at the Federal level, we really have only two options. That's to go back—and like you, I don't know how we go back—or we go forward, otherwise we die.

NEW DEPOSITS INVESTED IN MORTGAGES

The CHAIRMAN. Mr. Coles, do you have an opinion on the provision in the House bill that would require 60 percent of the thrift's new deposits to be invested in mortgages?

Mr. COLES. I don't think that I have any problem with that. We certainly don't. Basically that would be the same regulation that we, as a State chartered association, have to adhere to, so in terms of new deposits, I don't think that would be a problem. I think that savings and loans are in the business of making home mortgages. We don't want to be a bank, however we do want to exist. You can't help anybody if you aren't in existence. We help the homeowners through being able to give mortgages, but the problem right then is we have an earnings squeeze, and to help us to get back on our feet and turn the red ink into black ink, we need some

of these other powers. But putting 60 percent of the new money into mortgages would be no problem. That's right down our alley.

The CHAIRMAN. Mr. O'Brien, you recommend the full faith and credit of the United States stand behind the notes in this program. That would short circuit any question as to whether or not the insurance fund's resources are sufficient to cover the program. I've been advised that they clearly are. FSLIC indicated that even if the 6-month T-bill remains at 13.5 in 1982, and I would point out that currently it's at 11.67, FSLIC would only have $800 million in promissory notes outstanding out of a fund of $4.9 in billion market value and a revenue at $1.2 billion annually. Under the circumstances, it would appear from this data that the funds do indeed have sufficient resources to provide capital assistance at this time. Do you have any specific information or data to support your request for the full faith and credit?

Mr. O'BRIEN. I don't have anything specific, but I do know that there are contingent liabilities of the FSLIC that are not included in the data you've just cited, and nobody knows what they are. But they could be quite substantial in a rising interest rate environment, such as that predicted by economist Henry Kaufman, for instance. We don't know where the interest rate environment is going, and rather than have people speculate or calculate what these potential contingent liabilities may be and what the increasing actual liabilities may be, the full faith and credit ends the issue forever. It seems to us to be a logical step to stop the speculation.

The CHAIRMAN. I'm sure you are aware, as far as the deposit side, that both the House and Senate passed resolutions guaranteeing the full faith and credit behind the insurance fund on deposits.

Mr. O'BRIEN. We thought that was outstanding, and I think the next step would be to do as we've indicated.

The CHAIRMAN. You know, that's interesting. The reason I said, "I am sure you know," and maybe I shouldn't have said that, because just prior to that we had cover stories on national news magazines "Are Your Savings Safe?" and boy, it was big. Then after Chairman St Germain and I got together and passed those resolutions, I had a hard time finding the other side that yes, they are safe. The Government says that they are. We found little columns like this. We didn't quite get the front page on Newsweek to say yes, they are safe.

Mr. O'BRIEN. That's the old story that good news isn't news.

The CHAIRMAN. I'm sure that a lot of people are totally unaware that that action did take place.

Mr. BROOKS. Mr. Chairman, could I comment on that? You are certainly right that you didn't see the headlines that they are safe. We've been trying to do our bit through advertising. The Savings & Loan Foundation has had a whole series of ads, but a lot of people out there are still not aware of it. There's no doubt about it. We need to do a better job, and we are trying.

TEMPORARY OR PERMANENT PROGRAM

The CHAIRMAN. Mr. Gray, as I understand your testimony, particularly your scenario in your written testimony, institutions with assets representing not even 1 percent of industry assets which

would receive capital assistance provided under S. 2531 would reach a zero net worth by the end of 1983. This assumes the interest rate remains at 1981 rates. Clearly the present rates are already lower and coming down, and I hope they will continue to come down. Do you believe the capital assistance program should be a temporary program and not permanent?

Mr. GRAY. We believe it should be temporary, but we do think that it's essential in order to get the breathing space for everyone: the Congress; the regulators; and the institutions.

The CHAIRMAN. Gentlemen, unless you have anything else to add, I have a large number of additional questions and I'm sure there will be some from other Senators on the panel. The reason I cut you off without asking any more questions orally, we have a very difficult situation on the floor and right now it's quiet with two lights on. That means they are trying to decide what to do. [Laughter.]

When they finally decide what to do the parliamentary situation, we will deal with an urgent supplemental. We could get a string of votes. So with the other panels waiting, I would like to make certain before it breaks loose and the bells start to ring, unless they did get it delayed until this afternoon, that we will have the opportunity to hear the other witnesses.

Do you have anything else any of you would like to say?

[No response.]

The CHAIRMAN. We appreciate your testimony and will be submitting questions to you for your response in writing.

Thank you very much.

Next I would like to invite to the witness table Lee Gunderson, president of the Bank of Osceola, Wis., and chairman of the board of the American Bankers Association; Robert L. McCormick, Jr., president and chief executive officer, Stillwater National Bank, Stillwater, Okla., president of the Independent Bankers Association of America.

Gentlemen, we are happy to have both ou you here today. Mr. Gunderson, would you like to begin?

STATEMENT OF LEE GUNDERSON, PRESIDENT, BANK OF OSCEOLA, OSCEOLA, WIS., AND CHAIRMAN OF THE BOARD, AMERICAN BANKERS ASSOCIATION

Mr. GUNDERSON. Thank you, Mr. Chairman. I am Lee Gunderson, immediate past president of the ABA, now chairman of the ABA Council. We appreciate this opportunity to testify on S. 2531, the Capital Assistance Act of 1982, and on S. 2532, the Deposit Insurance Flexibility Act.

Mr. Chairman, you and other members of this committee are to be commended for introducing this legislation. We recognize that the primary thrust is to remedy the short-term problems of financially troubled depository institutions, and share your belief that the long-term solution to depository institutions' problems lies in significant Federal budgetary restraint and the updating of the Federal status prohibiting depository institutions from competing with the nondepository financial intermediaries.

Our association has on several previous occasions communicated our strong support for financial institution deregulation, as outlined in S. 1720. We hope that this committee will continue to take a comprehensive approach to financial institution legislation, and include those elements of S. 1720 on which there is substantial agreement in the regulated depository institutions community, along with the bills under consideration by the committee today.

SHORT-RUN EARNINGS PROBLEMS

Many depository institutions are currently facing short-run earnings problems caused by high interest rates. Certainly the thrift institutions are most troubled because they're financing low yielding, long-term assets with high-yielding, short-term liabilities. As a result, they are unable to maintain an acceptable interest rate spread and are experiencing negative earnings.

The current earnings problems of most depository institutions is short run in nature. To address the situation a revised regulators bill, S. 2532, should be expeditiously enacted to provide the regulatory agencies with an administrative safety net under financially troubled depository institutions. While we are not opposed to S. 2531, we see it as legislation of only marginal help to financially distressed institutions. In most cases, legislation assisting depository institutions in coping with the short-run problems does not cure the problem. A sustained period of lower interest rates accompanied by expanded powers is necessary to return many of the troubled depository institutions to long-run profitability.

Certainly, a necessary prerequisite to curing both the short- and long-run problems is a return to economic stability. Our association has gone on record supporting efforts to restore economic stability and to establish a credible budget program which will go a long way toward restoring confidence in the long-term direction of the economy.

However, I think to be realistic, we cannot necessarily expect that the adoption of a budget resolution would result in a rapid fall in interest rates. The credibility of savers and borrowers was lost over two decades of deficit spending, erratic monetary policy, inflation, and rising interest rates. It will be only restored by firm demonstration from policymakers sustained over time.

Lower interest rates will ease the short-run problems of many financial institutions. However, they'll be subject to the same earnings problem if rates again increase and don't accept the reality of the marketplace. The marketplace for consumer deposits no longer belongs exclusively to the depository institutions. High interest rates and regulation Q restrictions on rates to be paid on time and savings accounts have seen to that. Money market funds without rate ceilings and not subject to Federal Reserve requirements have attracted billions of dollars from depository institutions. These institutions will be at a disadvantage as long as they are prevented from competing effectively in the marketplace.

Repeated periods of losses for large numbers of depository institutions can be expected until legislation is enacted or regulations are changed to allow depository institutions to compete with money market funds. Market rate transaction accounts are needed on the

The Short-Run Problem

Many depository institutions are currently facing a short run earnings problem caused by high interest rates. The thrift institutions are most troubled because they are financing low yielding long term assets with high yielding short-term liabilities. As a result, they are unable to maintain an acceptable interest rate spread and are experiencing negative earnings. During 1981, the net worth of the savings and loan industry declined by $5.53 billion, a 17.1 percent decrease. Thrift industry losses have continued through the first months of 1982. While the focus of public attention has been on the problems of S&Ls and mutual savings banks, the commercial banking community is not immune from earnings difficulties stemming from our sizable holdings of under-water assets held in ouragriculture, municipal bond, real estate, small business, and consumer credit portfolios.

The current earnings problems of most depository institutions is short run in nature. To address this situation, the revised Regulators' bill, S.2532, should be expeditiously enacted to provide the regulatory agencies with an administrative safety net under financially troubled depository institutions. While we are not opposed to S.2531, we see it as legislation of only marginal help to financially distressed institutions. In both cases, legislation assisting depository institutions in coping with the short run problems does not cure the problem. A sustained period of lower interest rates accompanied by expanded powers is necessary to return many of the troubled depository institutions to long run profitability.

Budget Process

A necessary prerequisite to curing both the short and long run problems of depository institutions is a return to economic stability. Our Association stated in a consensus statement on national economic policy and high interest rates that was adopted by the ABA Banking Leadership Conference on April 30, 1982, that interest rates will not drop until savers and borrowers have regained confidence in the long-term direction of our economy. (See Attachment #1) Part of the loss in confidence is due to the Federal budget process which is out of control. A credible budget program will go a long way towards restoring confidence in the long-term direction of the economy.

However, one should not necessarily expect that the adoption of a budget resolution will result in a rapid fall in interest rates. The credibility of savers and borrowers was lost over two decades of deficit spending, erratic monetary policy, inflation and rising interest rates. It will only be restored by a firm demonstration from policy makers, sustained over time, that these policies will not be continued. As a first step in restoring credibility, Congress and the Administration must demonstrate that they are willing to make the hard choices needed to impose a significant restraint on the growth in Federal spending. In addition, it must be demonstrated that as Congress and the Administration move from an overly expansive to a more neutral fiscal policy, the Federal Reserve will not alter its current moderate monetary policies.

Long Run Problem

Lower interest rates will ease the short-run problems of many financial institutions. However, they will be subject to the same earnings problems if interest rates again increase unless they accept the reality of the market place. The market place for consumer deposits no longer belongs exclusively to depository institutions. High interest rates and Regulation Q restrictions on rates that can be paid on time and savings accounts have seen to that. Money market funds, without rate ceilings, and not subject to Federal Reserve requirements have attracted billions of dollars from depository institutions. Depository institutions will be at a disadvantage as long as they are prevented from competing effectively in the market place. Repeated periods of losses for large numbers of depository institutions can be expected until legislation is enacted or regulations are changed to allow the depository institutions to compete with money market funds. Market rate transaction accounts are needed on the liability side of the balance sheet, and expanded powers are needed on the asset side of the balance sheet.

Our Association feels that the long term interest of all depository institutions can be best served by expansion of competitive powers for all institutions. The consensus statement adopted by the Banking Leadership Conference, outlines our Association's position and is presented in Attachment 2. It demonstrates the willingness of our Association, given certain conditions, to support the extension to thrift institutions of various bank-like powers that would enable them to compete in the future.

Our Association strongly supports a comprehensive approach to deregulation of financial institutions. For the most part we agree with S.

1720 which would deregulate the depository institutions. Attachment 3 contains the specific legislative proposals of the American Bankers Association which increase the powers of commercial banks and thrift institutions, as well as our Association's recommendations with respect to S. 1720. We urge this committee to continue its efforts to achieve substantial deregulation for depository institutions.

Since the major competition faced by depository institutions in gathering deposits is from money market funds, depository institutions must have some way of gaining back the funds that have been drawn away by this competitor. Our Association has been urging for some time that the Depository Institutions Deregulation Committee act to increase the competitiveness of the depository institutions. We have been proposing three kinds of actions: (1) create an interest bearning transaction account a form of special NOW account — on which there would be no interest rate ceilings on the entire balance in the account as long as the balance was above $5,000; the NOW account ceiling would be imposed whenever the balance fell below $5,000 (2) establish a firm schedule for the deregulation of interest rate ceilings on all categories of time and savings deposits and (3) lower the minimum denomination of certificates with no ceiling from $100,000 to $25,000. The first action will let depository institutions compete much more effectively for the relatively large amounts of small consumer deposits that are currently being lost to money market funds. The second action will provide depository institutions with the time to adjust to ceilingless deposit accounts. By beginning with longer term deposits, it will also permit managers to better control asset and liability risk and attract longer term deposits most appropriate for longer term lending. The third action will let them compete much more effectively for some relatively large

consumer deposits and, more importantly, the large number of deposit accounts from small businesses, local governments, and non-profit institutions that are currently being lost to money market funds.

In its March 22 meeting, DIDC did agree to a firm schedule for deregulation of instruments, but did not approve the other two items. The Commitee did, however, create a new instrument that is not competitive with money market funds and will only cause a shifting of funds within and among depository institutions. An instrument that will allow depository institutions to compete with the money market funds is needed if depository institutions are to maintain their ability to serve their customer's needs.

S. 2532

S. 2532 provides expanded authorities for the Federal Deposit Insurance Corporation and Federal Savings, Loan Insurance Corporation and the Federal supervisory agencies to address the problems of financially distressed depository institutions. This legislation would authorize both regulatory agencies to provide financial assistance in the form of loans to, deposits in, or purchases of assets of troubled institutions. Such assistance would be permitted when "severe financial conditions exist which threaten the stability of a siginificant number of" insured institution, provided that such assistance will lessen the risk to the insurance fund.

In addition, the legislation includes special authority for the regulators to arrange interstate mergers or acquisitions of both failed and failing commercial banks and thrift institutions. The FDIC's interstate acquisition authority, unlike that of the FHLBB, would apply only to institutions in excess of $500 billion in assets.

The goal of S. 2532 is to provide flexibility to the Federal Deposit Insurance Corporation, the Federal Saving and Loan Insurance Corporation and the other Federal supervisory agencies to deal with financially distressed depository institutions.

Our Association believes the regulatory agencies should be provided this "safety net" mechanism subject to the following conditions:

1. The significant exceptions to current law provided for in the legislation must be temporary, and terminated in no more than two years.

2. The financial assistance authority granted to both the FDIC and FSLIC must be identical in its applicability to depository institutions under their jurisdictions.

3. The emergency merger and acquisition authority granted to the agencies must be fully comparable and patterned after that proposed for the FDIC. However, all possibilities for intrastate mergers and acquisitions must be exhausted prior to utilization of provisions for interstate mergers and acquisitions.

Therefore, although our Association supports enactment of S. 2532, we would strongly recommend that it be amended so as to include both a sunset provision as well as a directive to the regulatory agencies requiring that all possibilities for intrastate mergers and acquisitions should be exhausted prior to resorting to interstate options. The interstate options should focus on contiguous states or regional states before being considered on a nationwide basis. Also the eligible institutions in the same state as the institution being merged should have the option of meeting the bid of an out-of-state institution if that is higher. If the acquisition of a failing thrift institution across state lines by a bank holding company is necessary to preserve depositors' funds or public confidence in the financial system,

we believe the branching laws applying to banks in the state of the acquired institution should apply to the acquiring institution.

We believe that this position does not undermine our support for the principles of the McFadden Act and/or the Douglas Amendment to the Bank Holding Company Act. If the acquisition of a failing thrift institution across state lines by a bank holding company is necessary to preserve depositors' funds or public confidence in the financial system, we believe the branching laws applied to banks in the state of the acquired institution should apply to the acquired institution.

The ABA regrets the emergency circumstances which apparently make it necessary to legislate changes in public policy permitting interstate mergers or interstate acquisitions of financial institutions even on a temporary basis.

In legislating these emergency and temporary changes, we urge you to require that all possibilities for intrastate mergers or acquisitions be exhausted before interstate solutions are approved. Section [illegible] of Part B should be amended accordingly, including preference for contiguous states when an intrastate solution is not possible.

Moreover, our Association believes that if the regulatory authorities are given the powers to deal with financially troubled depository institutions as contained in S. 2532, there is little need for additional legislation such as S. 2531.

In addition, we believe that interstate possibilities should focus upon contiguous states before being considered on a nationwide basis. Finally, the eligible institutions in the same state should have the option of meeting the bid of an out-of-state institution. We believe that these conditions should also apply to S. 2532.

S. 2531

S. 2531 authorizes a program of aid to troubled depository institutions. The FDIC and the FSLIC are authorized to purchase capital instruments from institutions which have a net worth of 3 percent or less; have lost money during the previous 2 quarters; agree to comply with the terms established by the FDIC or the FSLIC; are able to remain solvent for the next six months and have at least 20% of their assets in residential mortgages. For institutions between 2 and 3 percent net worth, the FDIC or the FSLIC may purchase instruments equal to 30 percent of the institutions'actual losses. For institutions between 1 and 2 percent net worth, instruments in amounts equal to 40% of the actual losses may be purchased. For institutions with 0% to 1% of net worth instruments equal in amount to 50% of the loss may be purchased. We are told that the purchase would involve financial instruments only and no budget authorization or outlays would result.

We feel that capital assistance aid in the form of a capital assistance program separate and apart from S. 2532 is not needed. If, however, it is decided to give some aid, certain aspects need to be considered. Only institutions that are having problems because of general market conditions should be eligible for aid. There should be no disincentives for portfolio adjustment of the institution to the long run realities of the market place contained in the aid programs. Institutions that have need of aid because of poor management should not be eligible. Legislation which eases the problem of individual depository institutions and their management should not be used to bail out bad managers, but rather to aid good managers

in their adjustment to changed market conditions. This adjustment can best be accomplished by allowing the thrifts more diversity in their portfolios, and any aid should be considered as a bridge to that point. The best way to assure that aid is going to those institutions which deserve it, is to give the regulators discretion in determining the institutions which will be eligible for aid. Without this discretion, undeserving managements may receive aid, resulting in continued problems for such institutions.

To evaluate in a uniform fashion the many aid proposals being considered, a set of criteria incorporating these principles was developed and accepted by the Banking Leadership Conference of the Association. These criteria are contained in Attachment 4.

Our Association agrees with the general principle of giving aid in the form of capital certificates if aid is to be given. In this way there is no budget authorizations or outlays. We would suggest, however, that this program be in effect for a limited time period only. This prevents legislation enacted to solve a temporary problem from becoming permanent.

We also feel that, if authorized, the assistance should be made available on the same terms to all federally insured depository institutions which are experiencing difficulties. The legislation as written does this, but because of differences in the structure of depository institutions, it is biased towards savings and loan associations. Commercial banks in general have a lower percentage of assets in loans than do savings and loans. In December 1981, commercial banks held 56% of their assets as loans while savings and loans held over 78% of their assets in loans. To insure equality, we suggest that the eligibility requirement be changed so that institutions with at least 20 percent of the amount of their loans (as distinguished from assets) held in residential mortgages or securities

backed by such mortgages would be able to participate in the program.

Our Association as provided for in the bill agrees with subsidizing only a portion of the losses of the institutions. In this way the institutions are not isolated from the market forces and will still have an incentive to move toward profitability. We also agree with the provisions which give the regulators discretion in determining which institutions are eligible and in establishing other conditions that must be met if the institution decides to accept the aid. We feel that giving the regulators discretion in dealing with troubled institutions is vital to prevent misuse of aid that may be extended.

There is, however, one area where there has been too much discretion given to the regulators. In the proposed amendments to the National Housing Act and the Federal Deposit Insurance Act authorizing the FDIC of FSLIC to maintain the capital of qualified institutions, S.2531 states that the capital instruments may be purchased, ". . . for such form of consideration as the Corporation may determine, . . ." The Chairman's introduction to S. 2531 states that the assistance program would involve only an exchange of instruments and would not result in budget allocations or outlays. We feel that it should be explicitly stated in the legislation that the capital assistance will be in the form of financial instruments only.

We also question giving the FDIC and the FSLIC the opportunity to change the net worth criteria, the calculation of losses and the percentage of losses to be met by purchases of capital instruments. The FDIC and the FSLIC should not have the discretion to change the structure of the program such that there are no longer disincentives for participation in the program.

Finally, we feel that a clarification is needed on the periods for

which the FDIC of FSLIC may purchase the capital instruments from the qualified institution. The bill does not specify the time period of the losses for which the instruments would be purchased. For example, if the institution is eligible at the end of 1982, will the losses for all of 1982 be subsidized, or only those in the last 6 months?

Summary

In conclusion, our Association strongly supports the enactment of S. 2532, the revised regulator's bill, along with the modifications we suggested. The unanimity of support for this legislation by all the regulatory agencies underscores the importance of swift action in the enactment of S. 2532. Our Association does not oppose enactment of S. 2531 to provide Capital Assistance to all types of regulated depository institutions on an equal basis. S. 2531 is in our judgment preferable legislation to H.R. 6267, the Net Worth Guarantee Act, because it provides maximum flexibility to the regulators without incurring unnecessary additional federal budget obligations.

We urge the Committee to keep in perspective the fact that S. 2531 and 2532 are short-run solutions. Your Committee and this Congress have a unique opportunity to also address the long-term problems of depository institutions. One aspect of the troubled financial institution problem will only be cured by the accomplishment of a stable interest rate environment. Enactment of a credible budget resolution is the mandatory first step of the process to achieve ther desirable interest rate environment. The other aspect of the troubled financial institution problem results from regulated depository institutions inability to equitably compete against the unregulated intermediaries. The key to unlocking our ability to compete is contained in the various sections of S. 1720, and we hope that any markup of S. 2531 and S. 2532 will also consider S. 1720.

We will be pleased to respond to any questions. Thank you.

Attachment 1

THE FOLLOWING IS THE CONSENSUS STATEMENT
OF THE AMERICAN BANKERS ASSOCIATION
ON NATIONAL ECONOMIC POLICY AND HIGH INTEREST RATES
ADOPTED BY THE ABA BANKING LEADERSHIP CONFERENCE
FRIDAY, APRIL 30, 1982

Bankers understand the ravages caused by high interest rates. We see small businesses unable to cope with the twin blows of economic recession and high rates of interest. We see farm customers having great difficulty even servicing their seasonal working lines to say nothing of meeting land or equipment acquisition debt. We see the housing and automobile industries suffering dramatically from the high cost of funds. The high cost of our deposits prevents us from providing credit at reasonable rates to these customers. It is imperative that interest rates stabilize at a lower level. This is essential to the restoration of higher economic growth and lower unemployment.

We can say with total assurance that interest rates will not drop until savers and borrowers have regained confidence in the long-term direction of our economy. It is this economic uncertainty which adds a prohibitive premium to long-term interest rates. No one will be fooled by short-term solutions or empty promises.

The Federal budget process is out of control. Credibility will only be achieved when it becomes obvious that control has been reestablished. The current impasse between the Congress and the Administration cannot persist. We must know what to expect for fiscal 1983 and beyond even if the news is not entirely to everyone's liking. If either side opts out as a result of frustration or political posturing we will all be losers.

We continue to support the original four main elements of the President's economic program:

1. Significant reductions in the rate of growth of government spending.
2. Significant reductions in tax rates to stimulate savings and investment.
3. A monetary policy designed to achieve a significant and lasting reduction in the rate of inflation.
4. Significant reduction of the regulatory burden on businesses and individuals. We note that achievements in the banking industry in this area have been minimal.

At this juncture, three elements are necessary to a credible budget program: (1) a significant downward trend in the ratio of government spending to GNP; (2) a significant downward trend in the absolute dollar level of the budget deficit; and (3) an explicit indication from Congress and the Administration that they are willing to make hard choices on expenditures and, if necessary, taxes. If any of these elements are not achieved, any program will suffer a substantial loss in credibility. A reasonable objective for projected budget deficits has to be at least below $100 billion in FY 1983 and below $50 billion in FY 1985.

The first of the three elements stated above means that the great bulk of the deficit reduction measures should come from expenditure restraint and not tax increases. Preferably, all of it should come from expenditure restraint. Willingness to limit growth in entitlements and defense expenditures is

essential to achieve credibility in this area. A program meeting these criteria of credibility is a necessary prerequisite to significant reductions in interest rates. However, given the financial conditions created by past policy mistakes, we cannot be sure that such a program will actually succeed in significantly reducing interest rates but we are confident that without these elements there is no chance of success.

We prefer that no tax increases be enacted and that all deficit reduction measures come from expenditure reductions. If this is not possible, needed revenue increases should be in the form of taxes on consumption and not saving. Excise taxes and energy taxes come closest to this criterion, and we support them if they are necessary to achieve the criteria for credibility stated above. We would oppose abandonment of the enacted tax cuts, but we believe that there should be flexibility in delaying the implementation of the tax cuts if necessary to achieve the required reductions in the budget deficit.

Attachment 2

CONSENSUS STATEMENT

The American Bankers Association will seek in every possible forum and via every possible legislative vehicle the expansion of bank powers which is necessary to make banking competitive in the 1980s. This includes a permanent federal usury override, a permanent override of state prohibitions of due-on-sale clauses, significant relief from banking's regulatory burden (FIRA, Truth in Lending, and CRA, for example) and all the banking powers enumerated in ABA's earlier responses to S. 1720 and in ABA's banking agenda for change endorsed by the Banking Leadership Conference.

The highest prerequisite is the removal of impediments to the rational pricing of banking services -- Reg Q, usury statutes and the due-on-sale matter.

The Banking Leadership Conference reiterated its support for existing provisions of S. 1720 which override state prohibitions of due-on-sale clauses in mortgages; override state usury statutes; authorize bank underwriting of revenue bonds and offering of mutual funds, substantively reform the Truth in Lending Act; eliminate excessive restrictions in the Financial Institutions Regulatory Act; liberalize national bank lending and borrowing limits, real estate activities and the treatment of bankers' acceptances and of bank affiliates; and provide the regulatory agencies with additional powers they have requested to deal with troubled depository institutions.

Looking beyond these provisions, which currently are part of S. 1720, the Banking Leadership Conference concluded that modernization of banking laws to permit local banks to continue to serve the financial needs of their customers and communities must also include authorization for banks to offer a full line of insurance brokerage services, to provide investment advice and to offer full securities brokerage services; to make equity investments in real estate (as all other financial entities are permitted to do); and to engage in real estate brokerage, development and management activities.

Any acceptance by banking of any further bank-like powers for thrift institutions is dependent absolutely upon material progress toward deregulation in the March 22nd meeting of the DIDC. Such progress should include establishment of a dependable schedule for phasing out Reg Q and the differential and the creation of truly competitive, short-term deposit instruments.

Further, any acceptance by banking of any bank-like powers for thrifts is dependent upon Congressional support for banking's agenda for change. In any event, thrift institutions will have to make their own political case for expansion of their asset powers. To the extent that they are able to make that case convincingly, the following is a plan on which the members of the Banking Leadership Conference would be willing to seek wider agreement within the nationwide banking community:

* Provided that the statutory interest rate differential is repealed and DIDC directed to remove all existing differentials, all federal S&Ls would be permitted to originate, acquire, and hold up to 5% of their assets in commercial loans if such loans are made within the state where the S&L is located or within 75 miles of the S&L's home office, and to accept demand deposits which are tied to such commercial loans.

* At such time as Reg Q is phased out, federal S&Ls and federal mutual savings banks would be permitted to originate, acquire, and hold an additional 5% of their assets in commercial loans (for an aggregate of 10%).

* Any federal S&L or mutual savings bank wishing to originate, acquire, and hold more than 10% of its assets in commercial loans or 20% in consumer loans would be required to seek a bank charter as either a national or state chartered institution. As a bank, the former thrift institution would then have to comply with applicable state branching laws if any. In the event the branches were prohibited, the institution would be given two years to dispose of these branches. If branches are allowed, they could be retained. If holding company laws apply, the branches would have to be converted to holding company affiliates.

* In addition, all commercial banks should at their option be permitted membership in the Federal Home Loan Bank System similar to the status now enjoyed by some FDIC-insured mutual savings banks and life insurance companies. This provides the opportunity for banks active in mortgage finance to qualify for FHLBB advances and loans. Also, banks should have the option of converting their charters to federally insured savings and loans.

Regarding the special powers requested by the regulators to deal with troubled financial institutions, ABA renews its previous support for the regulators' bill, which generally is incorporated in S. 720, with further amendments suggested by the regulators (a $1 billion threshold to trigger application of the powers to failing banks and continued regulation by the FDIC of mutual savings banks converting to federal charters.

The determinant is whether the Congress, the DIDC and the thrift industry show by their actions a bona fide interest in working with banking for our agenda for change. A key measurement for this commitment will be the DIDC's March 22 decisions. If this commitment is evident, banking is prepared to reciprocate by working for the enactment of the regulators' bill, by considering a fiscally responsible program for dealing with the low-yielding mortgage situation of all depositories and by agreeing to the plan described above for thrift asset powers.

......Adopted by the Banking Leadership Conference on February 11, 1982 by a vote of 337-48 (with participation of the Iowa Bankers Association, Minnesota Bankers Association, and Virginia Bankers Association).......

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Attachment 3

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS

Gerald M. Lowrie
202/467-4097

March 8, 1982

The Honorable Jake Garn
Chairman
Senate Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

As indicated in our letter of February 16, enclosed are specific legislative proposals to authorize banks to provide insurance brokerage (Attachment I) and real estate related services (Attachment II). In addition, enclosed is an amendment that would authorize federally chartered savings & loan associations and mutual savings banks to invest a percentage of their assets in commercial loans and to accept demand deposits linked to those loans (Attachment III).

Our consensus statement sent to you on February 16, indicated that banking is seeking to expand its opportunity to provide its customers with expanded services in the insurance, real estate, and securities areas. While we are submitting specific amendments to expand banking's options in the real estate and insurance areas, we believe that statutory changes are unnecessary for banks to be involved in security activities sought at this time other than those provisions presently contained in S. 1720. The Federal Reserve Board will soon be considering whether a bank holding company may acquire as a non-bank subsidiary a brokerage house that offers securities. In view of existing law, the services to be offered by the proposed subsidiary and an earlier ruling by the Federal Reserve Board, there seems little reason to doubt favorable action. Should the Federal Reserve Board find, however, that full securities brokerage activities are not so closely related to banking as to be a proper incident thereto, we urge the Congress to amend the law to clarify that these activities are proper for banks and bank holding companies.

Enclosed is a tabular summary of ABA's recommendations with respect to S. 1720, incorporating our latest banking leaders' consensus statement.

We appreciate the continuing opportunity you have provided us to meet with you and your staff to discuss our position and we look forward to meeting with you to further discuss this latest consensus position.

Sincerely,

Gerald M. Lowrie

ATTACHMENT I

Insurance Sales

Amendment

S.1720 is hereby amended by deleting all of Title VI, pages 10, line 5 through 11, line 1, and substituting therefor the following new Title:

"TITLE VI — BANK INSURANCE ACTIVITIES

"Section 601. Section 18 of the Federal Deposit Insurance Act (12 U.S.C. [illegible]) is amended by adding at the end thereof the following new subsection:

''(m)(1) Notwithstanding any contrary provision of Federal or state law, any insured bank, as defined in Section 3 of the Federal Deposit Insurance Act, may, under such rules and regulations as may be prescribed by the appropriate Federal banking agency, provide, sell, or offer insurance as agent, or broker for and to itself, its customers, or any other person, provided, however, that no such insured bank shall guarantee the truth of any statement made by an assured in filing his application for insurance.

''(2) 12 U.S.C. Section 92 is hereby repealed.''"

Explanation of Amendment

This amendment would authorize all insured banks, whether Federally or State-chartered to sell a complete line of life, health, casualty and property insurance for their customers. It would also allow banks to provide blanket bond, property, casualty and other insurance for themselves and their employees. Any bank insurance activity under this provision would be subject to regulation by a bank's principal Federal supervisory agency, that is, the Comptroller of the Currency for national banks, the Federal Reserve Board for state member banks and bank holding companies, and the Federal Deposit Insurance Corporation for state nonmember banks.

Need for the Amendment

This amendment is needed to provide to banks the authority to compete effectively in the changing financial services market of the '80s. With insurance companies increasingly entering into the banking business directly, through purchases of commercial banks, and indirectly, through affiliation with, purchase of, or purchase by securities firms and money market mutual funds, banks need the ability to offer to their customers the complete range of financial services that may be offered by their competitors. In addition, national banks have, since 1916, had the authority to offer a complete range of insurance services in towns under 5,000 population. This amendment would extend that authority to all banks wherever located.

ATTACHMENT II

BANK REAL ESTATE ACTIVITIES - Section 203

Because the last amendment to Section 24 of the Federal Reserve Act was enacted in 1974, banks governed by that section are illequipped to face the real estate market of the '80s. Our Association strongly believes that language more appropriate to bank real estate activities than that contained in proposed Section 203 of S.1720 should be included in any final legislation, and that these real estate powers should also be extended to state-chartered banks because of the national interest in the health of housing and real estate finance. Accordingly, we offer the following amendment to Section 203.

Amendment to Section 203

On page 50, line 16 through page 53, line 10, delete Section 203 in its entirety and substitute therefor the following:

"Section 203(a). Section 24 of the Federal Reserve Act (12 U.S.C. 371) is amended to read as follows:

'Section 24(a) - Notwithstanding any other provision of Federal or state law, any insured bank, as defined in Section 3 of the Federal Deposit Insurance Act, may make loans on the security of liens on interests in real estate, may invest in real estate for its own account or an order or instruction of its customers, may purchase, hold, lease, manage and convey real property without limitation, and may purchase and sell real estate on its own account, or as an agent or broker for its customer.

'(b) Any loan, investment, lease, purchase or sale made pursuant to this section shall be subject to any terms, conditions or limitations which may be prescribed by the Comptroller of the Currency by rule or regulation.

"(b) Section 28 of the National Bank Act (Act of June 3, 1964, 12 U.S.C. 29), as amended, is hereby repealed."

'(c) Section 1(b) of the Bank Services Corporation Act (Pub. L. 87-856, 12 U.S.C. 1861 (b) is amended by adding before the period at the end thereof the following new language:

'and means, in addition, any services which a national or state bank in the state in which the bank service corporation is incorporated may lawfully perform for itself.'

Explanation of Amendment

This amendment would allow commercial banks to compete effectively with savings and loan associations, mutual savings banks, and mortgage banking associations by removing many of the outdated restrictions governing bank real estate lending, and by applying to state nonmember banks the same real estate lending provisions as those governing member banks. The amendmnet would provide the Comptroller of the Currency with regulatory authority in the real estate lending area as broad as that given elsewhere in S.1720 to the Federal Home Loan Bank Board.

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The amendment would also authorize banks, under the regulatory supervision of the Comptroller of the Currency, to invest directly in equity interests in real estate, to lease or manage real estate, and to provide real estate brokerage services. This equity investment authority is intended to allow banks to purchase real estate to be developed in the future in order to help keep land acquisition costs for real estate development under control. In addition, these provisions would allow national banks to take "equity kickers" so as to compensate themselves, in certain circumstances, for below market rate of interest loans to development companies with a share in the appreciation of the real estate under development or construction. These provisions could be both antiinflationary and countercyclical in assisting in the finance of real estate development in ways that help real estate costs and maintain real estate financing through all phases of the real estate economic cycle.

<u>Need for the Amendment</u>

This amendment is needed in order to permit bank real estate lenders to compete in the housing finance market of the '80s. Section 24 of the Federal Reserve Act is at present an ambiguous combination of archaic restrictions on real estate lending and jerrybuilt exceptions found vital to permit any national bank real estate lending. Originally enacted at a time when any real estate lending by banks, particularly residential housing credit, was considered at best a speculative activity, it has been designed more to keep lenders from making any risk decisions than to serve the real estate finance needs of bank customers.

To remedy this situation, this amendment would authorize banks to engage in real estate lending on the same basis as their savings and loan association competitors, leaving to the Comptroller of the Currency the duty to ensure through regulations, that real estate lending does not endanger the safey or soundness of the banking system. In addition to broadly authorizing bank lending on the security of real estate, the amendment would allow national banks to take equity interest in real estate, to manage, develop, or lease real estate, and to broker real property for their customers.

The amendment would also broaden the authority of bank service corporations so that service corporations could perform any service the banks that chartered them could perform. This authority would place bank service corporations on a par with savings and loan service corporations, particularly in such areas as real estate development.

ATTACHMENT III

Savings and Loan Limitations

Amendment

S.1720 is amended by adding after page 19, line 20 the following new sections:

"Section 136. Section 5(c) of the Home Owners' Loan Act of 1933 (12 U.S.C. 1464 (c)) is amended by adding at the end thereof the following:

'(7) Restriction. -Notwithstanding any other provision of this Section, no association may invest more than 5 percentum of its assets in any activity authorized under subsections 5(c)(1)(L) or 5(c)(1)(P) of this section or any activity incidental thereto until such time on the Depository Institutions Deregulation Committee eliminates all ceilings on the interest that may be paid by commercial banks and savings and loan associations on all categories of deposit accounts; and, provided further, that, at no time may any association invest more than 10 percentum of its assets in any activity authorized under subsections 5(c)(1)(L) or 5(c)(1)(P) of this section, or any activity incidental thereto.

'(8) Demand Deposits - No association may accept demand accounts from any person except those to whom they have made loans or in whom they have made investments under subsections 5(c)(1)(L) or (c)(1)(P) of this section.'

"Section 137. Section 102 of Public Law 94-200 (12 U.S.C. 461 note) is hereby repealed."

5/8/81

ABA

POSITION ON S. 1720

SUBJECT	ABA POSITION	FURTHER COMMENTS
A. Thrift Powers		
1. Conditions Precedent for Bank Support		
a. Sec. 207(b)(1) of P.L. 96-221 must be amended repealing the statutory differential of section 102 of P.L. 94-200 (12 U.S.C. 461 note) and DIDC directed to remove all existing differentials	ABA Initiative	This would repeal the only statutory basis for continuing a differential in deposit rate ceilings established by the Depository Institutions Deregulation Committee, and DIDC would be directed to remove all differentials immediately on enactment. ABA has proposed an amendment to accomplish this goal
b. Repeal 12 U.S.C. 1456 and 12 U.S.C. 1464	ABA Initiative	These provisions of the law place the Federal Home Loan Bank Board in the anomalous position of having "to encourage" and "to promote" savings and loan associations which they are also required to regulate. These statutory directions are inconsistent and have resulted in policies not comparably appropriate for the regulators of banks
c. Amend Sec. 203 of S. 1720 to authorize banks to invest directly in equity interests in real estate, to lease or manage real estate, and to provide real estate brokerage services	ABA Initiative	ABA has proposed an amendment to accomplish this goal
d. Amend Title VI by deleting the existing language and instead authorizing banks to provide a complete line of life, health, casualty, and property insurance for their customers	ABA Initiative	ABA has proposed an amendment to accomplish this goal
e. A new section should be added to Title I requiring any Federal S&L or Federal mutual savings bank that wants to invest more than 10% of its assets in commercial loans or 20% in consumer loans, within a reasonable period, to convert its charter to a bank as either a national or state chartered institution at its option and comply within a two year period with applicable state branching laws	ABA Initiative	ABA has proposed an amendment to accomplish this goal
f. Amend Section 4(a) of the Federal Home Loan Bank Act (12 U.S.C. Sec. 1424(a)) to permit commercial banks to become members of the Federal Home Loan Bank System.	ABA Initiative	ABA has proposed an amendment to accomplish this goal
B. *Thrift Powers Proposed* (Title I, Parts A and B)		
a. *Chartering and Purposes* (Sec. 111)		
This section would provide a parity of entitlements between Federal savings banks and Federal S&Ls.	Supports	

SUBJECT	ABA POSITION	FURTHER COMMENTS
b. Demand Accounts and Capital Stock (Sec. 112)		
— Grants FHLBB authority to permit Federal S&Ls to issue capital stock.	Supports	
-- Authorizes thrifts to offer any customer or corporation a demand account.	Supports only with ABA Amendment	ABA amendment provides that a thrift may only accept a demand account from a person to whom they have made a loan under Section 125. (Discussed further at item i on page 2 below.)
c. Conversion to Federal Charter (Sec. 113)		
Permits any institution that is a FHLBB member to convert to a Federally chartered institution	Supports with Amendment	Ability of mutual savings banks to be Federally chartered is subject to State law authorizing mutual savings banks and all activities of mutual savings banks are subject to branch limitations of Secs. 114 and 115. In states where mutual savings banks have not been heretofore recognized, Federal S&Ls should not be permitted to use the term bank.
d. Conversion to State Stock (Sec. 116)		
Authorizes state mutual to state stock conversions and vice versa involving insured institutions.	Supports	
e. Overdrafts (Sec. 121)		
Authorizes overdrafts to be issued with respect to any transaction account rather than only against NOW accounts.	Supports	
f. Real Property Loans (Sec. 122)		
Grants thrifts ability to invest up to 100 percent of the assets and loans secured by loans on residential or nonresidential real property.	Supports with Amendment	ABA amendments provide for parity of investment authority between thrifts and national banks and that all regulated depository institutions be permitted equity investments in real estate transactions.
g. Time Deposits (Sec. 123)		
Permits thrifts to invest in each others time and savings accounts.	Supports	
h. Government Securities (Sec. 124)		
Permits thrifts to invest up to 100 percent of assets in obligations or issues of state or local government.	Supports with Qualification	Banks are permitted to invest in government securities only if they are "investment" quality. Sec. 124 should be made to conform to bank investment powers under 12 U.S.C. 24 paragraph 7
i. Commercial, corporate, business, agriculture loans (Sec. 125)		
Authorizes thrifts to invest up to 100 percent of their assets in secured or unsecured loans for commercial, corporate, business, or agricultural purposes.	Supports only with ABA Amendment	ABA amendment provides that when the statutory interest rate differential is repealed and DIDC directed to remove all existing differentials, then all Federal S&Ls would be permitted to originate, acquire, and hold up to 5 percent of their assets in commercial loans if such loans are made within the state where the S&L is located or within 75 miles of the S&L's home office.

SUBJECT	ABA POSITION	FURTHER COMMENTS
		Thrift commercial lending activity would be made subject to the same rules of the Financial Institutions Regulatory and Interest Rate Control Act (P.L. 96-221) that govern banks. At such time as all interest rate ceilings are eliminated, Federal S&Ls and Federal savings banks would be permitted to originate, acquire, and hold an additional 5 percent of their assets in commercial loans (for an aggregate of 15 percent)
j. Housing and Land Development Loans (Sec. 126)		
Broadens the investment opportunity for land development and community development loans.	Supports	
k. Corporate Securities (Sec. 127)		
Permits thrifts to invest up to 100 percent of their assets in commercial paper and corporate debt securities.	Supports with Qualification	Banks have not been permitted to invest in corporate debt securities by regulatory interpretation of the Comptroller pursuant to Glass-Steagall limitations of 12 U.S.C. 24 paragraph 7. Any authorization of investment authority for thrifts in securities should also include banks.
l. Investment Companies (Sec. 128)		
Expansion of thrift investment opportunities to a wider variety of mutual funds.	Supports with Qualification	Banks be granted equivalent investment opportunities under existing banking laws.
m. Consumer Loans (Sec. 129)		
Increases the authorized investment in consumer loans for thrifts from 20 percent to 100 percent.	Opposes	ABA does not believe that there has been showing that S&Ls have come near to utilizing the 20 percent authority granted to them in 1980.
n. Personal Equipment Leasing (130)		
Authorizes thrifts to invest up to 10 percent of assets in tangible personal property leases.	Supports with Qualification	Provision be rewritten to specifically clarify that this section does not authorize any form of commercial lending.
o. Education Loans (Sec. 130)		
Authorizes thrifts to invest 100 percent of assets in loans for educational purposes.	Supports	
p. Service Corporations (Sec. 130)		
Broadens the investment authority of service corporations, authorizes investment of 3 percent of S&L assets in service subsidiaries, and grants additional powers.	Supports with Amendment	ABA supports an amendment to Sec. 103 to permit banks to engage in the same type of activities as bank service corporations and also authorizes bank service corporations to engage in any type of activity, which the FHLBB authorizes for S&L service corporations.
q. Small Business Investment Companies (Sec. 130)		
Authorizes thrifts to invest in small business investment corporations as previously allowed.	Supports	

SUBJECT	ABA POSITION	FURTHER COMMENTS
b. *Incidental Activities* (Sec. 131)		
Authorizes thrifts to engage in activities and ventures incidental to the exercise of authority conferred under the Home Owners Loan Act	*Oppose*	*ABA believes that this section utilizes virtually any new power not mentioned in the Home Owners Loan Act and recommends that it be rewritten to be more precise*
c. *Branching* (Sec. 136)		
Would deny favorable tax treatment for bad debt deduction in the case where thrift asset investment falls beneath 60 percent qualified asset test. In such cases, thrifts would be subject to McFadden-type branching restrictions.	*Supports with Amendment*	*ABA amendment would provide that in addition when the percentage of a thrift's assets loaned or invested in commercial and consumer loans (10% in commercial plus 30% in consumer) exceed 30% of an institution's assets, then the thrift will be required to convert its charter to a bank as either a national or state chartered bank and comply with all relevant branching laws. (See c on page 3*
d. *Holding Company Activities* (Sec. 134)		
Limits the activities permitted to S&L holding companies where asset mix falls beneath the 60 percent qualified asset test for bad debt deduction so that S&L service corporations would be restricted to activities available to multiple savings and loan holding companies under 12 U.S.C. Sec. 1730a(c)(2)	*Supports with Amendment*	*In addition when an S&L holding company's asset mix falls beneath the 60 percent qualified asset test, this section should provide that the S&L service corporation would also become subject to the Bank Holding Company Act as amended (12 U.S.C. 1841)*
B Commercial Bank Provisions Supported by ABA		
1. Due-on-Sale (Title I - Part C - Sec. 141)		
Part C of Title I would authorize lending institutions to enforce as written all "due-on-sale clauses" contained in loans secured by liens on residential real property	Supports with Amendment	ABA amendment would amend Sec. 141 by deleting subsection (c)(2) so that the Federal preemption of due-on-sale laws would be permanent and not subject to state override.
2. Increased Regulatory Authority (Title I - Parts D & E)		
These provisions of S. 1720 are essentially an embodiment of the regulators bill. They would authorize extraordinary assistance by the Federal Home Loan Bank Board and Federal Deposit Insurance Corporation in the form of loans to, deposits in, or purchases of the assets of individual members of troubled financial industries. In addition, these provisions contain special authority authorizing interstate acquisition of failing banks or savings and loans in certain extraordinary circumstances. FDIC's interstate acquisition authority, unlike that of FHLBB, would apply only to institutions in excess of $2 billion in assets, and only after efforts to find instate merger partners had failed.	Supports with Amendment	Our Association believes the regulatory agencies should be given this "safety net" mechanism provided that it is amended so as to direct the Federal Regulatory agencies to consider all possible mergers and acquisitions between institutions within the same state prior to the use of any interstate options. In addition, we would recommend that interstate possibilities focus upon contiguous states before being considered on a nationwide basis, and that the asset test for interstate bank acquisitions be lowered to $1 billion.
3. National Bank Lending Limits (Section 201)		
This section would authorize national banks to lend up to 15% of their capital and surplus, rather than the current 10%, to any individual borrower, and to lend up to 25% of capital and surplus on fully secured borrowings.	Supports with Amendment	Although ABA supports this provision on grounds that the present limit is too restrictive, we believe a better way of addressing single borrower limits would be an amendment to this provision to authorize the Comptroller of the Currency to establish single borrower limits for national banks.

SUBJECT	ABA POSITION	[illegible]
4. National Bank Borrowing Limits (Sec. 102) This section would eliminate the current restrictions on total borrowing in which a national bank may engage (100% of capital plus 50% of surplus) and substitute for them regulatory authority in the Comptroller of the Currency's office to set borrowing limits	Supports	Because we believe the flexibility inherent in this provision will allow banks and their regulators to better respond to changing economic circumstances, our Association supports this Section.
5. National Bank Real Estate Activities (Sec. 203) This section would substitute for the existing rigid and precise limitations of Section 371 the National Bank Act broad power for national banks to engage in real estate lending subject to the regulations of the Comptroller of the Currency.	Supports with Amendment	ABA amendments would simplify the language of the real estate lending provisions of the National Bank Act, allow broadened real estate lending authority for state chartered banks, provide for the same real estate powers as possessed by S&L service corporations, and allow banks to invest directly in equity interests in real estate, to lease [illegible] real estate, and to provide real estate brokerage services.
6. Bankers Acceptances (Sec. 209) This section would significantly increase the allowable acceptances that a member bank may accept. The present limitation of no more than 100% of capital and surplus could be raised by the Federal Reserve Board up to 200% of a member bank's capital and surplus.	Supports	The proposed changes to Section 13 of the Federal Reserve Act would enable U.S. banks to provide additional financing for U.S. exporters, reduce the cost of U.S. imports and strengthen the position of the U.S. as a trade and financial center -- all without any adverse impact on individual banks, the banking community, or the public. The ABA supports this provision
7. Bank Affiliates Act (Sec. 210) This section would substantially revise the existing restrictions on transactions between a member bank and its subsidiaries and affiliates by revising Section 23A of the Federal Reserve Act	Supports with Amendment	Our Association supports the objective of Section 210, however we believe one change should be made. As proposed Section 210 would eliminate a current exemption contained in Section 23A. If this exemption were eliminated, it would adversely affect institutions affiliated in either of two ways: 1) bank holding company subsidiary banks which are less than 80% owned by the parent holding company, and 2) so called "chain banking" systems due to the expanded definition of "affiliate". Our Association recommends that Section 210 be amended so as to preserve this specific exemption
8. Exemption from Reserve Requirements (Sec. 211) This section would exempt all depository institutions with less than $5 million in deposits from all reserve requirements.	Oppose	Our Association believes that if the issue of reserve requirements is going to be considered by Congress, it should be done in the context of a complete re-examination of the issue and not on a piecemeal basis as proposed by Section 211.
9. FIRA Amendments (Secs. 221-231) The provisions of these sections, while primarily technical in nature, would also provide substantial relief from some of the more restrictive provisions of the Financial Institutions Regulatory Act (FIRA). Among	Supports with Amendment	The Association's suggested amendments would delete the more onerous, costly, and ineffective provisions of FIRA. The amendments would permit loan approvals of loans to bank management officials to be made by committees of

SUBJECT	ABA POSITION	FURTHER COMMENTS
the major provisions of these amendments would be the deletion of any dollar limitations mortgage and educational loans to member bank executive officers, the elimination of the requirements that majority of the entire board of directors approve an insider loan transaction, and elimination of the applicability of loan approval requirements to the management officials of non-banking subsidiaries of bank holding companies		bank boards of directors rather than by the full board as presently required They would also allow board approvals to after a loan made rather than in advance a is required And would permit aggregate loans bank management official and his outside interests to be subject to state single borrower limits rather than national bank single borrower limits. In addition, the amendments would repeal required public disclosure of loans bank management officials and would provide that, where state maintained careful supervision of changes in bank control the Federal banking agencies would accept state approval procedures in lieu of duplicative applications.
10. Revenue Bonds (Sec. 301) This section would authorize banks to underwrite revenue bonds and other non-general obligations of state and local governments.	Supports	The Administration has proposed that revenue bond underwriting and mutual fund services should be offered through securities subsidiaries of bank holding companies ABA opposes this proposal We believe that a securities subsidiary requirement would provide a cumbersome and inefficient means for providing valuable customer services.
11. Bank Mutual Funds (Title 302) This section would authorize banks, bank holding companies, savings and loan associations, or credit unions to organize, sponsor, and control mutual funds, and underwrite, sell, or issue securities of any investment company.	Supports	
12. Usury Provisions (Title IV) The provisions of Title IV, subject to the regulation of the Federal Reserve System, would override state usury restrictions loan interest rates. They would authorize states their usury restrictions, but would also make permanent, unless voided by the States, a complete override affecting business and agricultural credit.	Supports with Amendment	ABA amendment would amend Section 403 by deleting Subpart Section 531(b)(1) and (c) so that the federal preemption of consumer credit laws would be permanent and not subject to state override.
13. Bank Holding Company Insurance Activities (Title VI) This title would prohibit bank holding companies from providing any insurance services except in certain excepted circumstances, but would grandfather all BHC activities in existence as of June 12, 1980.	Oppose	This title is not only inconsistent with our long standing position on competition, but it is inconsistent with other provisions in S. 1720 which tempt to level the field of play and so we oppose Title VI of S. 1720. ABA has proposed as an alternative that all insured banks be authorized to provide complete line of life, health, casualty, and property insurance for their customers (discussed at item A(1)(d) on page 1).
14. IRA/Keogh Deposit Insurance (Sec. 701) This section would increase deposit insurance for IRA/Keogh accounts from $100,000 to $250,000	Oppose	Our Association opposes Section 701. Any increase in insurance for certain specialized accounts historically leads to increased levels of insurance for all deposit

SUBJECT	ABA POSITION	FURTHER COMMENTS
		[illegible]. Such events would expose the insurance funds to significantly increased potential liability and higher assessment costs. This seems untimely under present economic conditions. Such an increase would also diminish the incentive for well managed institutions to continue to excel in the ability which separate them from institutions which are not as well managed.
14 **Truth-in-Lending Amendments** (Secs. [illegible]) These sections would further simplify the Truth in Lending Act.	Supports with amendment	ABA, in cooperation with an inter-industry group seeks to develop amendments to this legislation. We oppose the provision to include a state "opt out" alternative to the Truth in Lending law. In determining civil liability, ABA favors an amendment to ensure that the "substantial noncompliance" test is applied on a transaction by transaction basis.

Attachment 4

2/22/82

Banking Leadership Conference's
Criteria for Direct Assistance
To Troubled Depository Institutions

1. Any Federal aid should be direct, explicit, and in the budget, so that Congress has to vote specifically on the amount of aid given, and its duration.

2. The aid should be limited to a certain time period and not become institutionalized or automatically extended so that it can be ended after thrifts have made the necessary adjustments needed to become viable.

3. Any assistance should be available on the same terms to all federally insured depository institutions who are experiencing the same difficulties.

4. The assistance should entail serious disincentives to its use so that only institutions who have tried all other ways of alleviating their problems will opt to use it. Such disincentives might include penalty interest rates for long term loans, strictures on the type of business lines institutions may enter, the removal of managements, or refusal to grant FHLBB loans or Federal Reserve loans to institutions that did not properly diversify.

5. The type of assistance extended should be determined by whichever has the minimum present value cost to the agency extending the aid.

The CHAIRMAN. Thank you, Mr. Gunderson.
Mr. McCormick?

STATEMENT OF ROBERT L. McCORMICK, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, STILLWATER NATIONAL BANK, STILLWATER, OKLA., AND PRESIDENT, INDEPENDENT BANKERS ASSOCIATION

Mr. McCORMICK. Mr. Chairman, I'm Bob McCormick. I am president of the Independent Bankers Association of America, president and chief executive officer of the Stillwater National Bank in Stillwater, Okla.

In regard to S. 2532, the IBAA has been a strong supporter of the House-passed Regulators' bill. We have been urging Senate action on this bill for some time. We are pleased that this committee is turning its attention to this important piece of legislation.

Capital infusion into troubled thrifts and new authorities which promote the orderly merger and acquisition of troubled thrifts and failed banks are needed now. We have carefully reviewed S. 2532 and compared its provisions with the House-passed Regulators' bill. We are disappointed that S. 2532, as introduced, does not contain those amendments which were adopted in either the House Banking Committee or on the House floor. Those amendments were responsible for the overwhelming bipartisan support that the bill subsequently enjoyed.

Our specific comments and recommendations relate to the following sections:

SECTION 203, EMERGENCY THRIFT ACQUISITIONS

This section provides an order of precedence for the merger or acquisition of failing thrifts. This order of precedence insures the integrity of the thrift industry and protects the rights of States to determine their financial structure. However, unlike the House-passed bill, it is silent on the question of what rules will apply when Federal regulators permit a bank holding company to take over a failing thrift.

We believe that competitive equality dictates that when a thrift is taken over by a bank holding company, the thrift should come under the banking laws of the State. It is our understanding that this concept was written into the House-passed bill with the full support of the regulators. Unless the acquired thrift is placed under the banking laws of the State, State law will be circumvented and the acquiring bank holding company will have an enormous competitive advantage.

Without the State law provision in S. 2532, any thrift acquired by a bank or a bank holding company could continue to branch, even though commercial banks in many States cannot. In addition, the thrifts would continue to enjoy favorable regulation Q and tax treatment. This is clearly unfair and contrary to our goal of competitive equality. Thus, we strongly urge the committee to adopt language to place a thrift that is acquired by a bank or bank holding company under the applicable State banking laws, as regards branching.

Section 203 states, "The need to minimize financial assistance required of the corporation shall be the paramount consideration," in arranging merger and acquisition partners. The language then sets forth a takeover sequence which looks toward protecting the identity of the thrift industry while promoting an in-State solution. These takeover sequence considerations, which go to the heart of the financial structure issue, are not given "paramount consideration."

If this language is allowed to stand it clearly signals the regulators to consider superficially the possibility of arranging an intrastate takeover of a thrift by a thrift when an interstate takeover of the thrift by an out-of-State thrift or out-of-State bank holding company is cheaper to the FSLIC or the FDIC.

We understand why the harassed officials of the FSLIC and FDIC would seek legislation which essentially instructs them to accept the highest bid, regardless of source. However, we suggest that what may be in the interest of the FDIC and FSLIC insurance fund may not be the way to promote the type of financial structure best suited to meet the diverse financial needs of our Nation.

We strongly urge you to adopt the language agreed to by the House which would give the takeover order of preference (which looks toward minimizing the disruption to the existing financial structure) "equal consideration" with the effort to minimize the loss of funds to the insurance agencies.

SECTION 106, EXTRAORDINARY ACQUISITIONS

This section addresses the problem of the emergency acquisition of closed banks. It opens the door to a takeover of a failed bank by an out-of-State bank or bank holding company. To the best of our knowledge, the only large banks presently facing failure are large saving banks or mutual savings banks, not commercial banks. Thus, this committee should limit this extraordinary acquisition authority to the problem at hand as the House has already done.

Any out-of-State takeover of a failed bank breaches the Douglas amendment to the Bank Holding Company Act. By limiting this section to failed savings and mutual savings banks, this breach is minimized. The Chairman has announced previously that this committee will be reviewing the issues of the Douglas amendment and the McFadden Act in the near future. Until S. 2532 was introduced, all legislative discussion of the regulators' bill defined the problem in terms of failing thrifts and failed or closed banks. The wording of S. 2532 broadens this framework. The new wording not only covers closed banks, but also banks that the FDIC has determined, at its discretion, to be in danger of closing. This is a considerable broadening of the language of the House-passed bill and of the bill originally sent to the Hill by the regulators. We feel it provides the FDIC with too much discretion.

We had hoped that such broad-scale legislative grants of discretionary power to the regulators had gone out of style with this administration. It is particularly troublesome, since this extraordinary acquisition language is also no longer limited to savings and mutual savings banks.

Finally, S. 2532 has lowered the size of the institution covered by this extraordinary acquisition section from approximately the $2 billion level, which was the level requested by the regulators when the bill was before the House last fall, to $500 million. Changing events and the growing seriousness of the thrift problem do suggest that the $2 billion threshold level for failed savings banks and mutual savings banks may be too high. We recommend that the committee carefully ascertain the appropriate level.

In regard to S. 2531, its legislative concept is very important to the thrift and banking industry. There are apparently millions of Americans, including prominent nationwide broadcasters, who do not know the difference between a thrift and a bank.

The forced merger and acquisition of thousands of thrifts because their net worth fell below some arbitrary level due to generally distressed economic circumstances does little to further confidence in our Nation's financial system.

There are a limited number of banks carrying a heavy mortgage portfolio that are facing the same problems many thrifts are facing. We urge this committee to amend S. 2531 so that such banks would be eligible for the certificate exchange program.

The House did adopt language which establishes a measure of fiscal distress for commercial banks which is the equivalent, on the scale of which commercial banks are measured by their Federal regulators, to the net worth standard established by the legislation for thrift institutions.

We urge that language be adopted incorporating this same principle in S. 2531 so the small community banks which have met the housing needs of their communities and fallen on hard times as a result are not excluded from the benefits of the bill.

Mr. Chairman, it was not our intention to raise S. 1720 in the context of these hearings.

However, the lead story in the American Banker on May 18th, entitled "Garn Wants Early Action on Broader Thrift Powers," stated: "Senator Jake Garn (R.-Utah) said Monday that he hopes to have his Senate Banking, Housing and Urban Affairs Committee vote on broader powers at the same time it considers the capital aid and regulatory powers bill he introduced last Friday."

In this connection, we are pleased to be able to tell this committee that your chairman has discussed the issues in S. 1720 with the committees and leadership of the IBAA approximately one month ago. At this time, the chairman indicated that he wasn't going to dictate any solution, while expressing the hope that the thrift and banking industry could get together on the issues separating them.

The IBAA welcomed this assurance that there will be no dictated solutions, and we cooperated closely with the U.S. League in putting together the House-passed legislative response to the unprecedented crisis they are facing.

The Independent Bankers Association of America has carefully considered and constantly reviewed its position on according thrifts commercial and agricultural lending and consumer and corporate demand deposit powers. We continue to strongly oppose this concept. Our concerns reach beyond consideration of what this could do to the value of stock of many small commercial banks or the potentialy adverse effects of putting thousands of thrifts, many of

them in trouble, in head-to-head competition with thousands of banks. This will neither strengthen the thrift industry nor the commercial banking industry during these troubled times.

In previous testimony we have also raised concern about the effects of such a policy on financing the future housing needs of our Nation.

These matters have been and continue to be argued, and we really have nothing to add to the debate.

BANKING POWERS

However, there is one matter that hasn't been touched upon in previous testimony of this committee or the Judiciary Committees of the Congress. This matter must be carefully evaluated before any reasoned decision can be made on the question of according S. & L.'s commercial banking powers—powers that have been the historic foundation of the banking industry of this great Nation. This is the issue of merger and acquisition in the banking industry, the issue of greatly accelerated financial concentration that would occur if banking is no longer a "separate line of commerce" in the eyes of the courts.

An esoteric point, but not so esoteric that the issue hasn't been raised in the April 1981 issue of the Banking Law Journal and separately in the Economic Review of the Atlanta Fed, which devoted its whole April 1982 issue to this topic.

Writing in the Economic Review, the Wachovia Professor of Banking of the University of North Carolina, Robert Eisenbeis, wrote:

> Almost any broadening of the line of commerce would have the practical effect of liberalizing the range of acquisitions that would pass muster under the antitrust laws; the broader the line of commerce, the lower the estimated concentration ratios and the lower the probability of finding a section 7 (of the Clayton Act) violation. Thus, changing the line of commerce definition has the potential to precipitate a consolidation of the banking system.

Eisenbeis concluded his article by stating:

> We should also be careful not to take the redefinition of the line of commerce too lightly or view it with the blinders of a narrow technical legal focus. For to address the line of commerce issue without regard to the broader policy issues could set the financial system on an evolutionary path that would be difficult to reverse and that might erase the gains that increased competition has brought.

Giving thrifts traditional banking powers could lead the Supreme Court, in some future decision, to hold that banking is no longer a separate line of commerce. Such a decision would open the door for an unprecedented merger and acquisition wave affecting commercial banks.

We therefore ask that before this Congress takes legislative action which could have such wide-ranging impact on the structure of banking and the nature of the financial concentration in this country, the appropriate committees of the Congress at least review this matter.

Mr. Chairman, I ask that the article by Professor Eisenbeis in the Economic Review of April 1982 issue of the Federal Reserve Bank of Atlanta, the article entitled "Commercial Banking as a Line of Commerce and the Role of Thrifts," be included in the record at this point.

The CHAIRMAN. It will be.

[The information referred to follows:]

Economic Review

FEDERAL RESERVE BANK OF ATLANTA APRIL 1982

Regulatory Agencies' Approaches to the "Line of Commerce"

The Supreme Court defines commercial banking as the relevant "line of commerce" for evaluating the competitive effects of proposed bank mergers and bank acquisitions by bank holding companies.[17] That definition has remained virtually unchanged since it was first articulated in the 1963 Philadelphia National Bank (PNB) decision.[18] Subsequently, the banking agencies have generally adhered to the Court's cluster of products and services definition of commercial banking as the line of commerce.

However, recent legislative and competitive changes are radically altering traditional financial arrangements and the ways services are being provided. As more depository and nondepository financial institutions have begun to offer closer substitutes for bank services, applicants increasingly have argued that the traditional definition of commercial banking as the relevant line of commerce fails adequately to capture market realities. As a result of these changes, their arguments are generally falling on sympathetic ears; the agencies seem willing to move in the direction of modifying their method of analysis and/or the line of commerce definition. Certainly, there is now ample evidence that the agencies are giving more and more weight to competition provided by thrifts and to other market developments in certain types of cases.

This article reviews the product line concepts applied by the banking agencies in their case analysis and briefly discusses some policy issues the agencies face in significantly broadening the traditional definition. Interestingly, as the next section shows, the concept of commercial banking as a line of commerce did not originate in the PNB case. Moreover, the problem of the appropriate way to consider competition by nonbanks is not a new issue, and the willingness of the agencies to address this issue on a case by case basis is not a recent development.

Agency Actions Prior to the PNB Case

As Shay and Yingling (1981) indicate in their survey article, use of commercial banking as the line of commerce in bank acquisition cases was not originated by the Supreme Court in the 1963 PNB case. Rather, the concept can be traced to previous agency actions dating back as early as the 1952 divestiture decision by the Federal Reserve Board in the Transamerica Corporation

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both nonbanking and previous banking cases, the Court focused on the classes of customers most affected by the proposed acquisition and on the competitive implications for prices and availability of the group of services demanded by the affected customers. The Court chose not to focus on the implications for the merging banks and the variety of competitive forces affecting them. Second, the key class of customers in the Connecticut case was the commercial customer, and, more specifically, the locally limited commercial customer.

This series of Supreme Court decisions has clearly constrained the agencies from making significant modifications to the line of commerce. However, these decisions have had relatively little impact on the agencies' practice, established prior to PNB, of selectively considering thrift and other competitors where they believed appropriate.[26] Moreover, even the explicit findings in the Connecticut case have not significantly affected the agencies' analytic process, which on occasion has been inconsistent with that employed by the courts. Consideration of thrift and other competitors has not only tended to enter the agencies' analysis in different ways, but also has varied from case to case, both among agencies and within agencies over time.

For example, the FDIC was the first agency whose decisions began to contain explicit references to the Connecticut National decision. In approving the 1976 merger of two mutual savings banks in Maine, the FDIC cited recent changes in state law permitting mutuals to offer personal demand deposits, NOW accounts, certain types of commercial loans, and credit cards. The FDIC concluded that commercial realities transcended the Connecticut case—that the increased parity of powers for depository institutions in Maine require a viewing of a combined bank-thrift institution market, as well as the traditional separate (thrift) market, when determining the competitive impact of any proposed mergers in Maine.[27]

> "Consideration of thrift and other competitors has not only tended to enter the [regulatory] agencies' analysis in different ways, but also has varied from case to case..."

In two subsequent cases—one a year later involving two Maine mutual savings banks and one in 1980 involving two Maine commercial banks—the FDIC again analyzed the proposed mergers in first a narrower market and then in the combined bank-thrift market.[28] While the FDIC did treat all three cases in a parallel fashion, certainly its twin market analysis did not match that suggested by the courts.

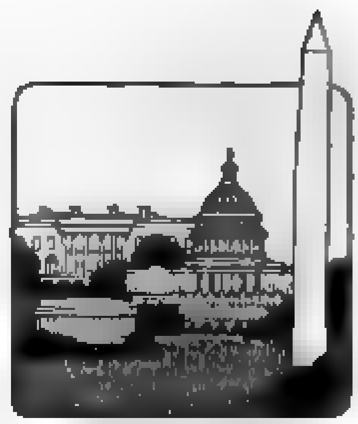
Moreover, the FDIC's finding that there was parity of powers was based upon a service by service comparison rather than on the ability to offer a package of services to particular customer classes. Only one of the products mentioned in the FDIC decision—the limited ability of mutual savings banks to offer commercial loans—would have enhanced the ability of mutual savings banks to service commercial enterprises, the key customer group in the Connecticut National Case. All of the other services mentioned by the FDIC were available only to consumers.

Following the Supreme Court's remand of the Comptroller's approval in the Connecticut National Case, there have been several other important cases in which the Comptroller considered thrift competition. In each instance, the approval decision made broad reference to the competitive influence of thrifts and other types of competitors without concern for particular classes of customers.[29]

Yet the Comptroller did consider the ability of thrifts to serve commercial and other specific customer segments in a 1980 denial of the merger between two Maine banks, Northern National Bank of Presque Isle and Merchants

National Bank of Bangor. In that case, the Comptroller specifically cited both changes in Maine law giving state-chartered mutual savings banks virtually identical powers to commercial banks and changes in federal law due to the Monetary Control Act giving broader powers to federal thrifts.

The Comptroller concluded that the overlap of services made thrifts significant actual or potential competitors...for almost all consumer financial services and an ever increasing number of commercial services.[20] More importantly, it was argued that a more realistic approach to merger analysis should include a disaggregation of the line of commerce into a number of product clusters and should reflect the degree to which thrifts and other financial institutions may compete in certain clusters and not in others. While the Comptroller did not actually apply such a disaggregate product line in the Maine case, it seemed to be attempting to lay the foundation for such an



analysis in a future case.

The Supreme Court's decision in the Connecticut National case had little noticeable impact on Federal Reserve analysis for several

HOW THE FEDERAL HOME LOAN BANK BOARD HANDLES SAVINGS AND LOAN ASSOCIATIONS' MARKETS

Like the bank regulatory agencies, the Federal Home Loan Bank System must approve or deny combinations of the institutions that it regulates. Unlike the banking agencies, the Bank Board has no court precedent defining either the geographic market or the line of commerce of these organizations. The Federal Home Loan Bank must apply competitive standards very similar to those that the commercial bank regulators apply; thus, it must decide on an approach to define relevant geographic and product markets.

The Home Loan Bank System's approach to the product of savings and loan associations contrasts sharply with that of the bank regulators and the courts. The intellectual basis for this approach dates to the early 1970s (Kaplan, 1970; Kaplan, 1971); even the Bank Board's most recent amendments to its merger regulations indicate its continued adherence to that approach (Federal Home Loan Bank Board).

The Bank Board's approach views savings and loan associations as primarily two-product firms. They offer insured savings instruments of small denominations and residential mortgages. Other savings and loan products have not been considered important in the past but may well be later. Since savings and loans are not viewed as having a special monopoly on any service (such as banks at one time had on checking accounts) and since they are not viewed as offering a special or unique cluster of services, the Bank Board has not tied the two products of savings and loans together in its analysis of mergers (Kaplan).

The Bank Board analyzes two markets: the market for small denomination (under $100,000 insured) savings instruments and the market for residential mortgages. Both markets are considered local. Newly amended Bank Board regulations delegating merger approval authority to the Regional Home Loan Banks are written in terms of county market concentration. Suppliers in the savings market include all insured depository institutions with offices in the local market: commercial banks, thrift institutions, and credit unions. Residential mortgage suppliers include all mortgage lenders making loans in the market.

The Home Loan Bank Board, thus, follows a different method of analysis from the banking agencies by identifying separate products and analyzing competition in each product market. Presently the two major markets in which savings and loan associations operate are given primary consideration. As these institutions expand the range of their services, questions of competition involving other products are likely to occur.

years. Prior to December 1979, the Board continued to follow the pattern it established in its 1974 approval of the merger of Northeast Bancorp Inc., New Haven, Conn. with The First Connecticut Bancorp, Inc., Hartford. In each instance, the Board evaluated the acquisitions using commercial banking as the line of commerce and proceeded to consider the impact of thrifts.[31] Such consideration usually consisted of noting (1) the size and number of thrifts in the area and (2) that thrifts and banks competed in many service areas, including consumer transaction deposits.[32] These factors were then used implicitly to discount the competitive significance of the proposed acquisition by an unknown weighting factor. As distinct from earlier cases, no combined commercial bank—thrift deposit shares were computed.

Not until December 1979, in a reconsideration of its earlier denial of an application by United Bank Corporation of New York to acquire the Schenectady Trust Company, did the Board refer to the Connecticut case. In the original application United Bank Corporation argued that New York thrifts had powers and provided services sufficiently similar to commercial banks to be included in the relevant product line. The Board noted that thrifts in New York could offer certain transactions accounts to consumers, but concluded that the cluster of products offered by commercial banks was still sufficiently distinct to constitute a separate product line.[34]

The applicant pressed the point in its request for reconsideration, citing additional changes in New York state law authorizing depository institutions to offer NOW accounts and prohibiting director interlocks. It also suggested that even if thrifts were not considered full competitors, commercial bank deposit market shares "...should be 'shaded' downward to account for direct competition between thrift institutions and commercial banks in certain product lines, and for competition from large out-of-market-based organizations whose small market shares do not adequately reflect their competitive influence in the relevant banking market."[35]

The Board recognized that thrift powers had expanded in many product areas and even the Supreme Court had recognized that the point would be reached where it would be appropriate to modify the line of commerce. The Board went further to indicate that thrifts and commercial banks might be grouped together for certain competitive analyses, but suggested that commercial banking might still be a relevant product line for smaller commercial enterprises. In the end, however, the Board rejected the applicant's arguments to include thrifts in the product line. The rationale is found in a footnote in the decision. The critical fact was that, while New York thrifts had been granted expanded powers, the range of permissible activities (and the extent they had been exploited) were not significantly different from the powers of Connecticut thrifts in 1974 when the Supreme Court refused to expand the product line definition. Thus, the Board concluded that New York thrifts were not yet significant competitors in offering services to commercial enterprises.

"[In a 1980 case,] the Comptroller concluded that the overlap of services made thrifts significant actual or potential competitors for almost all consumer financial services and an ever increasing number of commercial services."

Despite this negative conclusion, however, the Board still seemed to struggle for a way to give some weight to thrifts. In this regard, it embraced the concept of "shading," or discounting market shares, as the applicant suggested a means to "consider" the competitive thrust of thrifts.[36] While "shading" was not sufficient to carry the day in that case, the Board did begin to employ the methodology in subsequent cases.[37] Conceptually, "shading" is not significantly different from the other methods the Board used to "consider" the role of thrifts.[38] The important point, however, is that such a methodology does not focus on the commercial customer, the key customer class in the line of commerce; rather, it focuses on the broader competitive forces affecting the merging banks and customers not considered users of the critical product line.

Passage of the Monetary Control Act of 1980 and the broadening of investment and commercial lending powers of federal thrifts has heightened applicants' pressures on all the agencies to broaden

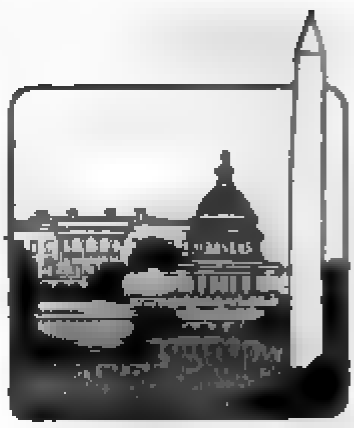
the line of commerce. The Board addressed the issue of whether passage of the MCA was sufficient to broaden the line of commerce in its order approving Fidelity Union Bancorporation's acquisition of the Garden State National Bank. In essence, the answer was "maybe, but not quite yet." The Board then followed its previous methodology of subjectively recognizing the presence of thrifts without references to the cluster of services provided for commercial enterprises.[39]

The Board was bothered by the Fidelity Union decision and the dilemma it faced in deciding whether the MCA broadened thrift institution powers enough for thrifts to be included in the line of commerce. The Board clearly felt constrained by the Connecticut National case but wanted to give more weight to thrifts in its merger analysis. In BHC Letter-198 of June 25, 1980 it instructed the Federal Reserve Banks and their staffs on how thrifts should be "considered." It indicated that the analysis should first look at the effects in "commercial banking" as traditionally defined, but then the staff was to collect data and other information to help determine the extent to which other financial institutions were also important competitors in providing transaction, credit and other services. These factors would be considered by the Board in making its final decisions.

Pressures for Change[40]

As the previous analysis shows, the federal banking agencies and the courts have had a difficult time defining the relevant product line to use in bank mergers and acquisition cases. The agencies have never been particularly comfortable with the Supreme Court's delineation in the PNB and subsequent cases. The agencies have always attempted—both before and after PNB—to take into account thrift and other competition, sometimes within, but more often than not outside, the constraints imposed by the Supreme Court decisions.[41]

"Despite this negative [1979] conclusion, however, the Board still seemed to struggle for a way to give some weight to thrifts."



Since the Supreme Court last addressed the issue seven years ago, pressures on the agencies to modify the line of commerce have heightened substantially. Numerous financial innovations and structural changes in financial markets are eroding the uniqueness of commercial banks as suppliers of demand deposits and the cluster of services that had traditionally set these institutions apart.

Moreover, these developments have reduced banks' cost advantages, and high interest rates have altered consumer preferences which had previously isolated banks from competition. The Monetary Control Act significantly broadened the deposit and asset powers of federal thrifts and authorized NOW accounts nationwide which has served to make banks and thrifts more homogeneous; legislation introduced during 1981 suggests that the realignment of thrift powers is not completed yet.

As interest rates have remained high, both consumers and businesses have also become more sophisticated in unbundling their use of financial services to earn the highest yields on their invested funds and to obtain credit at the most favorable rates. The growth of money market mutual funds has enabled smaller depo-

sitors to realize market rates on their savings. But the greater importance of money market funds may ultimately lie in their role in breaking down the dependence of locally limited consumers on local banks and thrifts for savings and transactional services, thus broadening the geographic scope of consumer financial markets.

The last two years have also witnessed the rapid spread of symbiotic financial arrangments in which independent firms cooperate to provide a service that could not legally or economically be offered by either firm separately. The best known example is Merrill Lynch's Cash Management Account. It combines a Merrill Lynch margin account, a Visa debit card and service arrangement provided by BancOne of Columbus, Ohio, and Merrill Lynch's money market mutual fund.

More recently, we've seen the creation of new types of financial institutions resulting from combinations of brokerage firms and other financial institutions, such as American Express-Shearson and Bache-Prudential. These institutions not only have institutionalized certain symbiotic financial arrangements, such as cash management services; they also are positioning themselves to take advantage of their freedom from reserve requirements and other regulations to offer a wide range of consumer and corporate financial, brokerage and insurance services.[42]

Whether these new institutions will be successful remains to be seen. They are, however, able to offer potentially superior substitutes to traditional banking services and can capitalize on the fact that many bank customers have learned it can be both convenient and cost effective to obtain financial services from nonlocal and nontraditional firms. It is important to realize that these recent financial innovations and competitive structural changes which have so concerned depository financial institutions affect primarily the types of services and alternatives available to consumers. For example, Bleier and Eisenbeis (1981) argued that the MCA granted thrifts few, if any, significant powers to enable them to offer services to corporate customers; this is especially true for S&Ls. The act does grant slightly broader authority to the few federally chartered mutual savings banks to offer certain commercial services, but even here quantitative limitations have been imposed. These limitations coupled with thrifts' present financial difficulties and the problems of acquiring the necessary management expertise should limit the overall competitive significances of these changes. Similarly, the cash management and money market fund services are also directed at consumers and not to the corporate customers.

> "But the Supreme Court has already indicated that 'fierce' competition in [retail banking] submarkets isn't sufficient to cause it to change the line of commerce definition."

Thus, many of the events now being cited by the applicants and regulatory agencies as the rationale for a re-examination of the line of commerce issue are occurring in the retail banking submarkets. But the Supreme Court has already indicated in the Connecticut National case that "fierce" competition in such submarkets isn't sufficient to cause it to change the line of commerce definition. Thus, to base a case for a change on the need to recognize the market realities of thrift competition in consumer markets is unlikely to be particularly persuasive. In fact, the Court might be convinced that the emphasis it placed in the Connecticut National case on the cluster of services provided to commercial customers is as relevant today as it was then, especially if the Court continues to direct antitrust to the protection of affected customer classes rather than looking at competitors.

So it is tempting to cling to the more traditional line of commerce and to focus on commercial customers. Yet there are also broader policy issues, as well as some potential pitfalls, in clinging too long to such a product line definition in today's changing financial environment, when the product constitutes a decreasing portion of many banks' business.

First, what happens as bank dependence on liability management and access to purchased monies expands as the primary source of bank funding? As commercial lending to small commercial enterprises declines as a portion of lending to consumers and large businesses, it

may pay many banks to abandon the small-commercial segment of their business. That's especially true if the result is to escape—or at least reduce—antitrust scrutiny. Thus, continued reliance on the traditional antitrust approach focusing on protecting affected classes of customers in a financial environment where funds are increasingly fungible, handicaps those firms whose services happen to be included in the relevant product line.

The traditional approach provides incentive for aggressive, expansion-minded banks to abandon their activities in the relevant product lines. The long run effect may be to drive out suppliers and reduce the number of effective competitors for those very customers and in those markets the policy seeks to protect. In effect, we are forced back to one of the key public policy issues addressed in the PNB case of whether the antitrust laws should apply to banking and, if so, how?

Second, even within the traditional approach, almost any broadening of the line of commerce would have the practical effect of liberalizing the range of acquisitions that would pass muster under the antitrust laws; the broader the line of commerce, the lower the estimated concentration ratios and the lower the probability of finding a Section 7 violation. Thus, changing the line of commerce definition has the potential to precipitate a consolidation of the banking system.

At the root then, of the line of commerce issue, are three questions: What type of a consolidation movement do we want to promote, how do we want it to proceed, and what role is antitrust to play?[43],[44] To illustrate the potential problems, suppose the arguments of many applicants are accepted and thrifts are included in the line of commerce. Because of the present difficulties of merging banks with thrifts due to statutory prohibitions and because operating a thrift is not a permissible activity for bank holding companies, the main impact of the broader definition would be to accommodate consolidations among banking organizations. But at a time when thrifts are in such financial difficulty, do we want, as a matter of public policy, to rationalize a further skewing of the relative size distribution of the financial industry in favor of banks?

Third, the policy problems are not eased if one follows the path recommended by the Comptroller in the Northern National Bank of Presque Isle case in which multiple "product line" clusters would be analyzed.[45] Such an approach may result in a tightening rather than a loosening of merger policy since a violation in any one of a number of relevant products lines would result in an antitrust violation. Perhaps, more importantly, however, is the increased regulatory burden that would be associated with such an approach. Data would have to be organized and collected on all the relevant product lines, not only from the merging banks, but also from all other institutions in the affected markets. At present, the only reliable data that can be organized on an approximate market basis are the FDIC Summary of Deposit data. Comparable data are not only costly to provide, but also are difficult to collect and process.[46] The problems and costs of extending such data to more than just deposits and to broaden classes of reporting institutions should not be taken lightly.

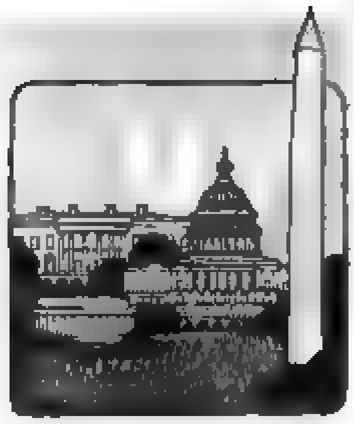
> "Yet there are . . . broader policy issues, as well as some potential pitfalls, in clinging too long to such a . . . definition . . ."

Finally, if one were to focus procedures of the FDIC and Federal Reserve Board on the competitive forces affecting banking organizations, rather than looking at affected product markets and classes of customers, the result would be a radical redirection of antitrust law from its traditional focus for all industries. In view of the large number of conglomerate acquisitions successfully evaluated using the traditional methodology, it is difficult to argue that banking is so unique and presents such difficult public policy issues as to warrant a rethinking and reorientation of antitrust policy.

The analysis of agency decisions indicated that they wrestled with the problems of delineating the relevant line of commerce long before the

Supreme Court did in the PNB case. The agencies have never truly been comfortable with the Courts finding in that and subsequent cases. They have continually sought to take thrift and other competitors into account, even when such institutions were not significant suppliers of services to the relevant affected classes of customers. At the root of their difficulty is the problem of dealing with financial conglomerates which operate in many different product and geographic markets and are subject to a variety of competitive forces. As a result, the analysis they have employed has not always been consistent with that employed by the Supreme Court. The dilemma the agencies have faced has become more significant as banks have diversified into more product lines and markets, as financial innovations have broken down traditional customer relationships and dependence upon banks as suppliers of clusters of services, and as more and more diverse financial institutions have begun to offer close substitutes for banking services.

"We should be careful not to take the redefinition of the line of commerce too lightly . . ."



We are now faced with the problem of how to restructure the financial system and how we want the transition to that structure to proceed. In that respect, antitrust policy is but one element that needs to be considered. All the same, we should also be careful not to take the redefinition of the line of commerce too lightly or view it with the blinders of a narrow technical legal focus. For to address the line of commerce issue without regard to the broader policy issues could set the financial system on an evolutionary path that would be difficult to reverse and that might erase the gains that increased competition has brought.

—Robert A. Eisenbeis

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COMMERCIAL BANKING AS THE "LINE OF COMMERCE" AND THE ROLE OF THRIFTS

Michael E. Bleier* and Robert A. Eisenbeis**

Now at Mellon Bank Now At University of North Carolina

Should thrift institutions be included in federal antitrust analysis of proposed commercial bank mergers and acquisitions? To answer this question, the authors review the leading Supreme Court decisions concerning the relevant product market, consider the impact of the Depository Institutions Deregulation and Monetary Control Act of 1980 on competition between commercial banks and thrifts, and discuss recent actions taken by the regulatory agencies. They conclude by suggesting various approaches that could be taken to modify the "line of commerce" definition.

Introduction

The Depository Institutions Deregulation and Monetary Control Act of 1980 (Public Law 96-221) (Monetary Control Act), signed into law March 31, 1980, broadens both the asset and liability powers of savings and loans, mutual savings banks, and credit unions. This raises the question of whether thrift institutions should be factored into the competitive analysis of bank holding company acquisitions and bank mergers through a redefinition of the "line of commerce."

The new law significantly narrows the distinctions among the powers and services of thrifts and commercial banks in many respects by authorizing:

- Nationwide NOW accounts at all federally insured depository institutions (effective December 31, 1980);
- Remote service units for federally insured savings and loan associations (effective March 31, 1980);

* Assistant General Counsel, Legal Division, Board of Governors of the Federal Reserve System.

** Senior Deputy Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System.

- Share draft accounts at federally insured credit unions (effective March 31, 1980);
- Federally chartered savings and loan associations to (1) invest up to 20 percent of assets in commercial real estate loans; (2) invest up to 20 percent of assets in commercial paper, debt securities, and consumer loans; and (3) issue credit cards;
- Federally chartered mutual savings banks to (1) accept demand deposits in connection with a commercial, corporate, or business loan relationship; and (2) make commercial, corporate and business loans up to 5 percent of assets within the state in which the institution is located or within seventy-five miles of the institution's home office.

Broadening the "line of commerce" definition could significantly alter the framework for evaluating the competitive effects of a proposed acquisition under the antitrust laws. In particular, it could expand the range of permissible acquisitions that would otherwise have been precluded under the existing "line of commerce" definition. Therefore, any change has important implications for public policy as well as for its effects on institutions seeking to expand by acquisition.

This article reviews the relevant Supreme Court decisions and recent approaches taken by the regulatory agencies to the "line of commerce" definition, outlines the issues raised by the new Act, and suggests how these decisions and approaches may provide a basis for the establishment of new precedents.

Supreme Court Opinions

Any decision to include thrift institutions in the competitive analysis of commercial bank mergers and acquisitions must be assessed in the context of previous Supreme Court opinions concerning the relevant product market or "line of commerce" definition. While these opinions may be regarded as imposing constraints on the flexibility to modify the "line of commerce" definition, they also provide guid-

ance as to what hurdles may have to be overcome in order to sustain any alternative definition.

Although numerous lower courts have included thrift institutions in the same product line with commercial banks, the Supreme Court has never upheld a case in which thrift institutions were included in the relevant product market with commercial banks. Instead, the Supreme Court has held consistently that commercial banking is a separate "line of commerce," distinguished by a unique clustering of products and services not available at any other type of financial institution.

United States v. Philadelphia National Bank

The Supreme Court first addressed the definition of the appropriate "line of commerce" for evaluating the competitive effects of mergers between commercial banks in *United States v. Philadelphia National Bank.*[1] The Court stated that "the cluster of products (various kinds of credit) and services (such as checking accounts and trust administration) denoted by the term 'commercial banking' . . . composes a distinct line of commerce."[2] The Court found that commercial banks offer products and services that are unique, that enjoy cost advantages or that enjoy settled consumer preferences which sufficiently insulate them from effective competition from other sources so as to constitute a separate line of commerce.

United States v. Phillipsburg National Bank & Trust Co.

The *Philadelphia* decision was reaffirmed by the Supreme Court in *United States v. Phillipsburg National Bank & Trust Co.*[3] In *Phillipsburg*, the Supreme Court overruled a lower court decision that considered competition between commercial banks and other types of financial institutions based on the fact that the character of the merging institutions' business made them more like savings institutions.

[1] 374 U.S. 321 (1963).
[2] *Id.* at 356.
[3] 399 U.S. 350 (1970).

The Court rejected the lower court's focus on such submarkets within the commercial banking "line of commerce," finding that the existence of submarkets was not a basis for disregarding a "broader line of commerce that has economic significance."[4] The Court stated:

> [I]f commercial banking were rejected as the line of commerce for banks with the same or similar ratios of business as those of the appellee banks, the effect would likely be to deny customers of small banks—and thus residents of many small towns—the antitrust protection to which they are no less entitled than customers of large city banks. Indeed, the need for that protection may be greater in the small town since, as we have already stated, commercial banks offering full-service banking in one institution may be peculiarly significant to the economy of communities whose population is too small to support a large array of differentiated savings and credit business.[5]

The Court reiterated that it was the "cluster of products and services" that full-service banks offered that as a matter of trade reality made commercial banking a distinct "line of commerce." In the Court's view, it was the gathering together of all financial products and services in one place—a department store of finance—that made commercial banking a separate "line of commerce" with economic significance beyond the individual products and services offered.

United States v. Connecticut National Bank

The Supreme Court last addressed the issue six years ago, in *United States v. Connecticut National Bank*.[6] The lower court had found that savings banks were direct and substantial competitors of commercial banks in providing financial services such as real estate mortgages, personal loans, and some commercial loans, and it observed they soon would be able to offer personal checking accounts. Nevertheless, although recognizing that savings banks and commercial banks were "fierce competitors" in certain service markets, the Supreme Court held that commercial banks

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[4] *Id.* at 360.
[5] *Id.* at 361-362.
[6] 418 U.S. 656 (1974)

offered a unique cluster of services that distinguished them from other types of financial institutions for purposes of antitrust analysis. Of foremost importance to the Court was the lack of significant competition between savings banks and commercial banks in offering a unique cluster of services to commercial enterprises, including the lack of commercial lending and business demand deposit services by mutual savings banks. The Court also noted that while commercial banks in Connecticut offered credit card plans, loans for securities purchases, trust services, investment services, computer and account services, and letters of credit, savings banks did not.

Although the Supreme Court has repeatedly refused to broaden the "line of commerce" to include thrifts, it has not foreclosed the possibility that changes in the powers of thrift institutions will eventually warrant their inclusion in the same product market with commercial banks.[7] In the *Connecticut* decision, the Court explicitly foresaw this development with respect to savings banks and indicated that a change in the "line of commerce" definition was a distinct possibility in the future:

> At some stage in the development of savings banks it will be unrealistic to distinguish them from commercial banks for purposes of the Clayton Act. In Connecticut, that point may well be reached when and if savings banks become significant participants in the marketing of bank services to commercial enterprises. But, in adherence to the tests set forth in our earlier bank merger cases, . . . we hold that such a point has not yet been reached.[8]

Agency Actions

The appropriate weight to be given to the presence of thrift institutions in evaluating the competitive effects of bank

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[7] Most recently, the U.S. District Court for the District of New Jersey rejected the idea that the "line of commerce" should be modified to include thrift institutions. Based on its reading of the *Connecticut* case and the Supreme Court's emphasis on the unique cluster of services that commercial banks provide commercial customers, the district court concluded that "it cannot yet be said that thrift institutions have become 'significant participants in the marketing of bank services to commercial enterprises.'" (United States v. First Nat'l State Bancorporation, 499 F. Supp. 793 (D.N.J. 1980).)

[8] United States v. Connecticut Nat'l Bank, note 6 *supra*, at 666.

acquisitions is an issue the agencies have wrestled with even prior to the passage of the Bank Merger Act of 1960 (12 U.S.C. § 1828(c)).[9] The issue was unresolved until the *Philadelphia* decision. Thereafter, the banking agencies traditionally have adhered to the Supreme Court's cluster of products and services definition of the "line of commerce."

The agencies, however, have been sympathetic to modifying the concept to include thrift institutions. For example, while not formally broadening the "line of commerce," the Federal Reserve Board has recognized competition provided by thrift institutions as a factor to be considered in evaluating the competitive effects of particular acquisitions. The weight given to the presence and role of thrift institutions has been greatest in those cases where thrift institutions are large in absolute size or play a dominant role in providing financial services within either a specific market or state. This issue has been most clearly drawn in cases in the Northeast. For example, in New England, mutual savings banks typically are large, have a greater share of total deposits than commercial banks and offer transactions accounts to consumers in the form of NOW accounts.[10] Similarly, in New York and in New Jersey mutual savings banks and other thrifts are large, have an expanding array of powers and play a significant deposit-taking role.[11] Outside the Northeast, the Fed-

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[9] For example, the Federal Reserve Board defined mutual savings banks to be competitors of commercial banks in the case of an application by Baystate Corporation, Boston, Massachusetts to acquire Union Trust Company of Springfield, Springfield, Massachusetts (44 F.R.B. 13 (1958)). However the Board excluded from its competitive analysis the competition offered by savings and loan associations in the case of an application by First Bank Stock Corporation, Minneapolis, Minnesota, to acquire Eastern Heights State Bank, Minneapolis, Minnesota (46 F.R.B. 486 (1960)).

[10] See Federal Reserve Board decisions of April 4, 1974, approving the merger of two Connecticut bank holding companies (60 F.R.B. 375 (1974)), and of November 2, 1978, approving the acquisition of a commercial bank by a New Hampshire bank holding company (64 F.R.B. 967 (1978)). It should be noted that the Board's 1974 *Connecticut* decision cited above, involving the merger of the third and ninth largest commercial banking organizations in Connecticut, was issued shortly before the *Connecticut* opinion was handed down by the Supreme Court.

[11] See Federal Reserve Board decision approving an application under Section 18(c) of the Bank Merger Act by Bank of New York Company, New York, New York, to merge with Empire National Bank, Middletown, New York (66 F.R.B. 793 (1980)), and Board decision approving the acquisition by Key Banks, Inc., Albany, New York, of The National Bank of Northern New York, Watertown, New York (66 F.R.B. 781 (1980)). In its order

eral Reserve Board has held, until recently, that the role of thrifts has not been sufficient to mitigate the anticompetitive effects of an acquisition.[12] Upon reconsideration of the proposed acquisition of Fort Sam Houston Bankshares, Inc., San Antonio, Texas by Republic of Texas Corporation, Dallas, Texas (decided November 28, 1980 with a statement setting forth the Board's analysis December 22, 1980), the Board noted that although thrifts were not considered as full competitors of commercial banks, the facts indicated that thrift competition in San Antonio was sufficient to reduce the adverse competitive effects of the proposal. This decision seems to reflect the evolving view of the Board that greater weight should be given to the presence of thrifts in markets generally.

The Comptroller of the Currency appears to have gone even further in recognizing the presence and role of thrifts.[13] In addition, both the Comptroller of the Currency and the FDIC have formally expanded the "line of commerce" in Maine where they have included thrift institutions as full competitors of commercial banks.[14] The rationale was based

approving the merger of Bank of New York and Empire National Bank, the New York State Banking Department held that thrift institutions should be considered as full competitors of commercial banks for competitive analyses purposes. (See press release of June 5, 1980, issued by the New York State Banking Department.) On two earlier occasions, the Federal Reserve Board appeared to give less weight to competition afforded by thrifts and denied applications under Section 3(a) of the Bank Holding Company Act by United Bank Corporation of New York (UBNY), Albany, New York, to acquire The Schenectady Trust Company, Schenectady, New York. UBNY contended that the Board's competitive analysis should include the presence of thrift institutions in the relevant banking market (64 F.R.B. 804 (1978), and 66 F.R.B. 61 (1980))

In the case of New Jersey, see application by Fidelity Union Bancorporation, Newark, New Jersey, to acquire Garden State National Bank, Paramus, New Jersey (66 F.R.B. 576 (1980)).

[12] See Federal Reserve Board decisions on applications filed under Section 3(a) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. § 1842(a)), by (1) Republic of Texas Corporation, Dallas, Texas, to merge with Fort Sam Houston BankShares, Inc., San Antonio, Texas (66 F.R.B. 580 (1980)); (2) Texas Commerce Bancshares, Inc., Houston, Texas, to acquire the First National Bank of Port Neches, Port Neches, Texas (66 F.R.B. 584 (1980)); and (3) Republic of Texas Corporation, Dallas, Texas, to acquire Citizens National Bank, Waco, Texas (66 F.R.B. 787 (1980)).

[13] See decisions by the Comptroller of the Currency in the matter of applications under Section 18(c) of the Bank Merger Act (12 U.S.C. § 1828(c)) of (1) Pacific National Bank of Washington, Seattle, Washington, to acquire American Commercial Bank, Spokane, Washington (decided Feb. 21, 1980); (2) The Citizens Bank of Shelby, Shelby, Ohio, to merge into BancOhio National Bank, Columbus, Ohio (decided Jan. 7, 1980); and (3) National Bank of Paulding, Paulding, Ohio, to merge with National Bank of Defiance, Defiance, Ohio (decided Dec. 12, 1980).

[14] See basis for Federal Deposit Insurance Corporation approval of the proposed merg-

on changes in state law that permit Maine thrift institutions to provide NOW accounts and personal demand deposits, to issue credit cards and to grant or to participate in certain kinds of commercial loans.[15]

Impact of New Thrift Powers

In the six years since the Supreme Court lást reviewed the "line of commerce" issue in the *Connecticut* case, thrift and commercial banking institutions have tended to become more homogeneous and the Monetary Control Act significantly broadens the potential overlap of thrift and commercial bank functions and services, particularly for federal mutual savings banks.[16] However, the Act also imposes important quantitative restrictions on the extent to which these new powers can be exploited by thrifts. Whether, in view of the quantitative limits, the expanded powers of thrifts would be sufficient for the Supreme Court to broaden the "line of commerce" definition is uncertain. Based on the *Connecticut* opinion, there is reason to believe that the ability of thrifts to offer commercial lending and deposit services may not be sufficient to persuade the Court to include thrifts with commercial banks in the "line of commerce" definition. In *Connecticut*, the Court discounted the significance of commercial lending by savings banks because of the low

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ers of (1) the Bangor Savings Bank, Bangor, Maine, with Piscataquis Savings Bank, Dover-Foxcroft, Maine, FDIC's 1976 *Annual Report*, pp. 78-79; (2) Bangor Savings Bank, Bangor, Maine, with Eastport Savings Bank, Eastport, Maine, FDIC's 1977 *Annual Report*, pp. 60-61, and (3) Report of the Board of Directors of the FDIC to the Comptroller of the Currency on merger of Northern National Bank, Presque Isle, Maine, with Merchants National Bank of Bangor, Bangor, Maine (dated June 16, 1980); and decision by the Comptroller of the Currency on the merger of Merchants National Bank of Bangor, Bangor, Maine (decided Dec. 12, 1980)

[15] In reviewing proposed mergers between S&Ls, the Federal Home Loan Bank Board does consider commercial banks to be competitors for deposits; commercial bank deposits less than $100,000 are used in calculating market shares. Competition in the mortgage market is also evaluated and a broad range of competitors are considered including commercial banks, mortgage bankers and credit unions where appropriate

[16] Further dimensions of this homogeneity are reflected in the creation of the FFIEC, the phase out of Regulation Q and the phase in of reserve requirements on transaction balances Although uniform regulation of depository institutions has not been a factor in Supreme Court decisions, it could be assigned some significance in the future to the extent that such uniformity of regulation impacts upon the competitive equality of depository institutions.

volume of such business that savings banks had relative to commercial banks. At the same time, the language in *Connecticut* that "at some stage in the development of savings banks it will be unrealistic to distinguish them from commercial banks for purposes of the Clayton Act," holds out the possibility of a future change in the Court's view on this issue.

The immediate short-run impact of the Monetary Control Act on competition between commercial banks and thrifts may be less significant than is commonly believed. First, the ability of thrift institutions, and especially mutual savings banks, to exploit the new asset powers is limited because the powers generally are available only to federally chartered institutions.[17] Second, the quantitative limits restrict the aggregate amount of nonmortgage loans and investments that may be made.

The new commercial lending and demand deposit powers of mutual savings banks, for example, apply only to savings banks with federal charters; only three of which exist at present.[18] An increase may be anticipated in conversions to federal charters by mutual savings banks eager to take advantage of the new powers, and states very likely will be induced to amend their laws to maintain competitive equality between state and federal savings banks.[19] But conversions and changes in state law take time. Thus, the immediate impact over the next few months of the expanded commercial deposit and lending powers of mutual savings banks—the critical powers relevant to the Supreme Court's findings in *Connecticut*—will be minor. Indeed, the longer-run impact might also be viewed by the Court as insignificant. Even if all mutual savings banks obtained equivalent commercial

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[17] It should be recognized that some state-chartered thrifts may have possessed many of these powers under state law prior to the enactment of the new Act.

[18] As of year-end 1980, three applications had been approved by the Federal Home Loan Bank Board. Federal charters have been granted to the Newport Savings Bank, Newport, New Hampshire, Anchor Savings Bank, New York, New York, and Citizens Savings Bank, Ithaca, New York. At year-end, sixteen applications were pending, all involving New York savings banks.

[19] Parity legislation was enacted in New York and Massachusetts; New Hampshire and Maine had preexisting parity statutes. Similar legislation was considered and rejected in the 1980 sessions of the state legislatures in Pennsylvania and New Jersey

lending powers by conversion or through changes in state law, commercial loans still would be limited under the new Act to 5 percent of total mutual savings bank assets (or about $8 billion as of year-end 1979). Most of this business is concentrated in New York where commercial lending by the large money-center banks (both domestic and foreign) overshadows that of the mutuals.

The overlap of expanded services between federal savings and loan associations and commercial banks is even smaller than between federal mutual savings banks and commercial banks. The major increase in product overlap would be in services provided to retail consumer customers. However, little in the way of expanded services to corporations would be available from savings and loan associations, which was critical to the Supreme Court's failure to expand the "line of commerce" definition in the *Connecticut* case.

Broader "Line of Commerce" Issues and Possible Agency Options

The new legislation represents another step in what has been a continuing erosion of the differences among financial institutions. As such, it offers the opportunity to reexamine the validity of the rationale the courts have used to define "line of commerce." Quantitatively, the impact is likely to be greatest with respect to the array of services provided to consumers. There are likely to be few if any important distinctions between thrifts and commercial banks in the retail consumer area. The Supreme Court has indicated, however, in both *Phillipsburg* and *Connecticut*, that expanded competition in such a subproduct area was not sufficient to cause it to change its "line of commerce" definition. Similarly, expansion of the cluster of services to businesses provided by federal mutual savings banks may not be determinative because the amount of loans that could be provided to commercial enterprises is severely limited.

The symbolic effect of the new legislation may be substantially more significant than the quantitative effects. It undoubtedly will prove to be the catalyst for taking a fresh look at the "line of commerce" issue. Indeed, recent deci-

sions[39] indicate that an in-depth review is already under way at all three of the banking agencies. Moreover, some believe that a redefinition is more likely because it is now also possible to identify other market changes that are both eroding the uniqueness of the "cluster of services" provided by commercial banks and, more important, reducing the cost advantages and customer preferences which in the past tended to effectively isolate banks from outside competition. For example, both consumers and business have become increasingly more sophisticated in unbundling their banking relationships, seeking the highest returns on invested funds while obtaining loans at the lowest possible cost. New sources of services from nonbanking institutions that did not exist when the Court last considered the "line of commerce" definition have become conveniently available. The growth of money-market mutual funds and credit card activities has served to reduce consumer reluctance and necessity to deal with a local commercial bank for a variety of financial services, including savings or lending services. Also important may be the trend toward explicit pricing of financial services which is eroding the incentives for customers to tie their purchase of financial services in "clusters." This trend is reinforced by the provisions in the Monetary Control Act calling for explicit pricing of Federal Reserve services, which the Board has already begun to implement.

In view of the changes that are occurring in financial markets, it is likely that the strongest and most convincing case to the Supreme Court would be based on evidence demonstrating that the "cluster of services" provided by banks no longer is unique, and, more important, that costs and customer (especially business customer) preferences no longer convey advantages to banks sufficient for them to be considered as a separate "line of commerce."

Approaches for Redefining the "Line of Commerce"

In light of these developments, it is possible to identify a range of approaches, though not an exhaustive listing, that

[39] See notes 12 and 13 *supra*.

could be used to modify the "line of commerce" definition. Among such approaches are the following:

(1) Maintain the current definition and analytic approach in the short run on the grounds that the ability of thrifts to service commercial enterprises may be sufficiently limited so as not to affect seriously the analytic framework used by the Supreme Court in the *Connecticut* case.
(2) Broaden the "line of commerce" to include mutual savings banks in those states where they operate on the grounds that they possess the potential to offer services to commercial enterprises.
(3) Identify two relevant sublines of commerce that would include:
    (a) Mutual savings banks, commercial banks, savings and loans, and credit unions as suppliers of retail consumer services; and
    (b) Only commercial banks and mutual savings banks (up to the amount of commercial business done) as suppliers of services to business.
(4) Broaden the "line of commerce" into two areas focusing on the asset and liability sides:
    (a) Fund-raising activities of banks, savings and loans, mutual savings banks, money-market funds, and other suppliers of transaction and thrift services to depositors; and
    (b) Lending activities of banks, savings and loans, mutual savings banks, commercial finance companies, commercial paper, life insurance companies, and other institutions.

The rationale for this approach would lie in the fact that banking and financial services may have become sufficiently separable insofar as customers are concerned to invalidate the cluster of services concept that was previously relevant in insulating banks from the competition of other institutions.

Whatever approach the agencies and the Supreme Court may take to the "line of commerce" definition, the practical effect of a broadening of the definition would be to liberalize to some extent federal policy toward mergers among financial institutions.[21] A redefinition, therefore, has the potential to precipitate a consolidation of the financial industry and affect future structure and competition. The broader the definition, the more permissive acquisition policy would be, and the likelihood of finding substantially adverse competitive effects under the antitrust laws would be reduced. This in turn raises broader public policy issues of how a new wave of consolidations should proceed—as a transition—and what the optimal financial structure should be. Finally, it also raises the question of whether the existing antitrust laws—especially in view of the Justice Department's failure to achieve a favorable Supreme Court ruling in any of the potential competition cases it has brought—are adequate to assure that the new structure that may evolve is likely to be optimal and in the public interest.

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[21] However, adopting an analysis based upon an extensive disaggregation of product lines could result in the application of a more strict antitrust standard because the Supreme Court has held that a substantial elimination of competition in any identifiable economically significant submarket is itself a violation of the Clayton Act. (Brown Shoe Co. v. United States, 370 U.S. 294, 325 (1962).)

Mr. McCormick. In closing, Mr. Chairman, the IBAA would like to make one additional point.

One of the purposes of S. 1720, as we understand it, is to give banks new tools that will allow them to compete with money market mutual funds. How depository institutions will do this while they're carrying deposit insurance, reserve requirements, and all kinds of regulations remains an open question.

Apparently the perceived mechanism contained in S. 1720 for allowing us to compete is statutory authority to offer money market mutual funds out of our banks. Frankly, this proposed mechanism will do little to keep funds in thousands of our smaller cities and communities. What would help would be the DIDC authorization of a new competitive, transaction account product which would allow us to pay competitive rates for the funds being presently channeled out of our communities and into a few money center banks.

Unfortunately, our quest for such a competitive instrument has run into difficulties in the DIDC, difficulties that it is important for all of us to understand.

I ask unanimous consent that a letter on this subject that I have received from Chairman Volcker be placed in the record at this point.

The Chairman. We'll also include that letter.

Mr. McCormick. Thank you, sir. This concludes the IBAA testimony. I would be happy to answer any questions.

[The complete statement and letter follow:]

WRITTEN STATEMENT

OF THE

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman, my name is Robert L. McCormick, Jr. I am President of the Independent Bankers Association of America and President/Chief Executive Officer of the Stillwater National Bank and Trust Company of Stillwater, Oklahoma.

I am pleased to have the opportunity to express the views of IBAA on S. 2532, a revised Regulators' bill, and on S. 2531, a bill to provide financial assistance to depository institutions.

IBAA represents 7200 national and state chartered small and medium-sized banks located in rural and suburban areas in 48 states and the District of Columbia. Over 80 percent of our banks have assets of $25 million or less. Banks of this size account for approximately 11.4 percent of all commercial bank assets but supply most of the credit needs of individuals, farmers and small business in their communities. Seventy-five percent of our member banks serve rural areas; 17.5 percent serve suburban areas.

S. 2532

The IBAA has been a strong supporter of the House-passed Regulators' Bill. We have been urging Senate action on this bill for some time. We are pleased that this Committee is turning its attention to this important legislation. Capital infusion into troubled thrifts and new authorities which

promote the orderly merger and acquisition of troubled thrifts and failed banks are needed now.

We have carefully reviewed S. 2532 and compared its provisions with the House-passed Regulators' Bill. We are disappointed that S. 2532, as introduced, does not contain those amendments which were adopted in either the House Banking Committee or on the House floor. Those amendments were responsible for the overwhelming bi-partisan support that the bill subsequently enjoyed. Our specific comments and recommendations relate to the following sections:

Section 203--Emergency Thrift Acquisitions

A. This section provides an order of precedence for the merger or acquisition of failing thrifts. This order of precedence insures the integrity of the thrift industry and protects the rights of states to determine their financial structure. However, unlike the House-passed bill, it is silent on the question of what rules of the game will apply when federal regulators permit a bank holding company to take over a failing thrift. We believe that competitive equity dictates that when a thrift is taken over by a bank holding company, the thrift should come under the banking laws of the state. It is our understanding that this concept was written into the House-passed bill with the full support of the regulators. Unless the acquired thrift is placed under the banking laws of

the state, state law will be circumvented and the acquiring bank holding company will have an enormous competitive advantage.

Please note the Board of Governors of the Federal Reserve System approved the takeover of the Scioto Savings Association of Columbus, Ohio by a bank holding company (the Interstate Financial Corporation of Dayton, Ohio). The Board specificially limited Scioto's branching to "that permitted under the branching laws of the state of Ohio, as if Scioto were a commercial bank." The Board also ordered that Scioto come under Reg Q ceilings within two years.

Without the state law provision in S. 2532, any thrift acquired by a bank holding company could continue to freely branch, even though commercial banks in many states cannot. In addition, the thrift would continue to enjoy favorable Reg Q and tax treatment. This clearly is unfair and contrary to the goal of competitive equality of treatment.

Thus we strongly urge the Committee to adopt language to place a thrift that is acquired by a bank or a bank holding company under the applicable state banking laws as regards branching.

B. Section 203 states "the need to minimize financial assistance required of the corporation shall be the paramount consideration" in arranging merger and acquisition partners. The language then sets forth a takeover sequence which looks towards protecting the identity of the thrift industry while

promoting an in-state solution. These latter takeover sequence considerations--which go to the heart of the financial structure issue--are not given "paramount consideration."

If this language is allowed to stand, it clearly signals the regulators to consider superficially the possibility of arranging an intrastate takeover of a thrift by a thrift when an interstate takeover of the thrift by an out-of-state thrift or out-of-state bank holding company is cheaper for the FSLIC or FDIC. We understand why the harrassed officials of the FSLIC or FDIC would seek legislation which essentially instructs them to accept the highest bid regardless of its source. Paramount in their minds is the protection of their insurance funds. However, we suggest that what may be in the interests of the FDIC and the FSLIC insurance funds may not be the way to promote the type of financial structure best suited to meet the diverse financial needs of this nation.

We strongly urge you to adopt the language agreed to by the House which would give the takeover order of preference (which looks towards minimizing the disruption to the existing financial structure) "equal consideration" with the effort to minimize the loss of funds to the insuring agency.

Section 106--Extraordinary Acquisitions

This section addresses the problem of the emergency acquisition of closed banks. It opens the door to a takeover

of a failed bank by an out-of-state bank or bank holding company. To the best of our knowledge, the only large banks presently facing failure are large savings banks or mutual savings banks, not commercial banks. Thus this Committee should limit this extraordinary acquisition authority to the problem at hand as the House has already done. Any out-of-state takeover of a failed bank breaches the Douglas Amendment to the Bank Holding Company Act. By limiting this section to failed savings and mutual savings banks, this breach is minimized. The Chairman has announced previously that this Committee will be reviewing the issues of the Douglas Amendment and the McFadden Act in the near future. The issue of whether a bank holding company should be allowed to cross state lines to acquire a commercial bank should be deferred until that time.

Until S. 2532 was introduced, all legislative discussions on the Regulators' Bill defined the problem in terms of failing thrifts and failed or closed banks. The wording of S. 2532 broadens this framework. The new wording not only covers closed banks but also banks that the FDIC has determined at its discretion, to be in danger of closing. This is a considerable broadening of the language of the House-passed bill and of the bill originally sent to the Hill by the regulators. We feel it provides the FDIC too much discretion. We had hoped that such broad scale legislative grants of discretionary power to the regulators had gone out of style

with this Administration. It is particularly troublesome since this extraordinary acquisition language is also no longer limited to savings and mutual savings banks. In making this point, we are not questioning the discretion or good judgment of Chairman Isaac; but history has taught us that we may not always be that lucky in the appointment of a future FDIC Chairman.

Finally, S. 2532 has lowered the size of the institution covered by this extraordinary acquisition section from the approximate $2 billion level, which was the level requested by the regulators when the bill was before the House last fall, to $500 million. Changing events and the growing seriousness of the thrift problem do suggest that the $2 billion threshold level for failed savings banks and mutual savings banks may be too high. We recommend that this Committee carefully ascertain the appropriate level.

S. 2531

The IBAA remains hopeful that last year's economic measures will be buttressed by a compromise on the budget which will lead to declining interest rates. This will take pressure off the S&L industry, among other industries. S. 2531 and its counterpart measure--which has now passed the House--looks towards stabilizing the net worth situation of troubled thrifts over the short term until interest rates do come down.

This legislative concept is very important to the thrift and banking industry. There are apparently millions of Americans including prominent nationwide broadcasters who do not know the difference between a thrift and a bank. The forced merger and acquisition of thousands of thrifts because their net worth fell below some arbitrary level due to generally distressed economic circumstances does little to further confidence in our nation's financial system.

There are a limited number of banks carrying a heavy mortgage portfolio that are facing the same problems many thrifts are facing. We urge this Committee to amend S. 2531 so that such banks would be eligible for the certificate exchange program.

The House did adopt language which establishes a measure of fiscal distress for commercial banks which is the equivalent, on the scale on which commercial banks are measured by their federal regulators, to the net worth standard established by the legislation for thrift institutions. We urge that language be adopted incorporating this same principle in S. 2531 so the small community banks which have met the housing needs of their communities and fallen on hard times as a result are not excluded from the benefits of the bill.

The IBAA supported and worked for passage of the bill that just passed the House.

S. 1720

Mr. Chairman, it was not our intention to raise S. 1720 in the context of these hearings.

However, the lead story in the American Banker on May 18 entitled, "Garn Wants Early Action on Broader Thrift Powers," stated, "Senator Jake Garn (R-Utah) said Monday that he hopes to have his Senate Banking, Housing and Urban Affairs Committee vote on broader powers at the same time it considers the capital aid and regulatory powers bill he introduced last Friday."

In this connection we are pleased to be able to tell this Committee that your Chairman has discussed the issues in S. 1720 with the Committees and leadership of the IBAA approximately one month ago. At this time the Chairman indicated that he wasn't going to dictate any solution while expressing the hope that the thrift and banking industry could get together on the issues separating them. The IBAA welcomed this assurance that there will be no dictated solutions and we cooperated closely with the U.S. League in putting together the House-passed legislative response to the unprecedented crisis they are facing.

The Independent Bankers Association of America has carefully considered and constantly reviewed its position on according thrifts commercial and agricultural lending and consumer and corporate demand deposit powers. We continue to strongly oppose this concept. Our concerns reach beyond

consideration of what this could do to the value of stock of many small commercial banks or the potentially adverse effects of putting thousands of thrifts--many of them troubled--in head-to-head competition with thousands of banks. This will neither strengthen the thrift industry nor the commercial banking industry during these troubled times. In previous testimony we have also raised concerns about the effects of such a policy on financing the future housing needs of our nation. We realize that arguments are being made on both sides of this question. Those who oppose granting thrifts traditional banking powers--which include many groups most active in home construction and sales--argue that the thrifts' commitment to housing finance should not be diluted. Others--including those who serve on august Presidential panels--argue that giving thrifts a commercial lending window will only enhance their future financing of housing. Our own belief is that those promoting the view that giving thrifts new commercial lending powers will enhance their future commitment to housing are overstating their case.

These matters have been and continue to be argued, and we have nothing new to add to the debate.

However, there is one matter that hasn't been touched upon in previous hearings of this Committee or the Judiciary Committees of the Congress. This matter must be carefully evaluated before any reasoned decision can be made on the question of according S&Ls commercial bank powers--powers that

have been the historic foundation of the banking industry of this great nation. This is the issue of merger and acquisition in the banking industry...the issue of greatly accelerated financial concentration that would occur if banking is no longer a "separate line of commerce" in the eyes of the courts.

An esoteric point, but not so esoteric that the issue hasn't been raised in the April 1981 and April 1982 issues of the Banking Law Journal and separately in the Economic Review of the Atlanta Fed which devoted its whole April 1982 issue to this topic.

Writing in the Economic Review, the Wachovia Professor of Banking of the University of North Carolina Robert Eisenbeis wrote:

> almost any broadening of the line of commerce would have the practical effect of liberalizing the range of acquisitions that would pass muster under the antitrust laws; the broader the line of commerce, the lower the estimated concentration ratios and the lower the probability of finding a section 7 (of the Clayton Act) violation. Thus, changing the line of commerce definition has the potential to precipitate a consolidation of the banking system.

Eisenbeis concluded his article by stating:

> We are now faced with the problem of how to restructure the financial system and how we want the transition to that structure to proceed. In that respect, antitrust policy is but one element that needs to be considered. All the same, we should also be careful not to take the redefinition of the line of commerce too lightly or view it with the blinders of a narrow technical legal focus. For to address the line of commerce issue without regard to the broader policy issues could set the financial system on an evolutionary path that would be difficult to reverse and that might erase the gains that increased competition has brought.

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Giving thrifts traditional banking powers could lead the Supreme Court in some future decision to hold that banking is no longer a separate line of commerce. Such a decision would open the door for an unprecedented merger and acquisition wave affecting commercial banks.

When the Supreme Court last reviewed this issue in the case of United States vs. Connecticut Bank in 1974, the Court did not foreclose the possibility that changes in the power of thrifts institutions could warrant their inclusion in the same product market with commercial banks.

We ask that before this Congress takes legislative action which could have such wide-ranging impact on the structure of banking and the nature of financial concentration in this country, the appropriate Committees of the Congress at least review this matter.

In closing, Mr. Chairman, the IBAA would like to make one additional point.

One of the purposes of S. 1720 as we understand it is to give banks new tools that will allow them to compete with money market mutual funds and Sears. How depository institutions will do this while carrying deposit insurance, reserve requirements and all kinds of regulations remains an open question. Apparently the perceived mechanism contained in S. 1720 for allowing us to compete is the statutory authority to

offer money market mutual funds out of our banks. Frankly, this proposed mechanism will do little to keep funds in thousands of our smaller cities and communities. What would help would be DIDC authorization of a new competitive, transaction account product which would allow us to pay competitive rates for the funds presently being channeled out of our communities into a few money center banks.

Unfortunately, our quest for such a competitive instrument has run into difficulties in the DIDC--difficulties that it is important we all understand. I ask unanimous consent that a letter on this subject that I have received from Chairman Volcker be placed in the record at this point.

Thank you. This concludes the IBAA testimony, and I would be happy to answer any questions.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

PAUL A. VOLCKER
CHAIRMAN

April 9, 1982

Mr. Robert L. McCormick, Jr.
President
Stillwater National Bank and
Trust Company
Sixth & Main Streets
Stillwater, Oklahoma 74074

Dear Mr. McCormick:

I read with great interest your letter of March 29. My concerns about the competitive pressure on the deposit base of banks and thrifts represented by shifts to money market funds--such as those you indicated are occurring at your bank--led to my request at the last DIDC meeting that the staff present within 30 days proposals for a genuinely competitive deposit instrument which could be used to reverse such trends. However, while I have not yet seen the staff's proposals, I am concerned about two aspects of any such instrument, particularly one similar to that you propose.

My staff estimates that, on average in 1982, banks and thrifts (excluding credit unions) will have about $285 billion of savings accounts if the DIDC takes no action on a new account. This estimate assumes that savings accounts continue to run-off. My concern is the cost impact of accelerating this shift. For example, suppose that the high-rate NOW account you proposed pays a 13 percent rate and that institutions could invest any new money attracted at a 2 percentage-point spread (which would be difficult), then if only 10 percent of the savings account balances that would have otherwise stayed in their present form shift to the new instrument, then banks and thrifts would have to attract over $100 billion of new deposit inflows just to break even on the 7-3/4 percentage-point increase on each dollar of internal shift from savings accounts. At the end of March, non-institutional money funds had a total of $160 billion. This arithmetic suggests to me the necessity of designing a new instrument so as to limit as far as possible shifts from passbook savings accounts at banks, and particularly at

thrifts, to the new instrument. The dilemma is made more difficult because the variables that will limit shifts--high minimum denomination and/or some short maturity or notice (such as seven days)--will reduce the attractiveness of a new account relative to money funds.

My own assessment of your $7,500 NOW account proposal relates to the potential for significant internal shifts in the context of my concerns about costs. It would have the same liquidity and insurance as a savings deposit, yet pay a higher rate. A small ABA sample survey last month indicated that 30 percent of savings deposit balances at commercial banks--and almost half of NOW balances--were in excess of $10,000. Similarly, at the end of last year, over 40 percent of savings bank passbook accounts were in accounts with balances in excess of $15,000. This heightens the concern that a significant porportion of funds would shift to your proposed account, resulting in a sharp increase in costs and the need for dramatic new money inflows to reduce--let alone eliminate--the impact on earnings.

Moreover, I have a monetary policy concern about a transaction account paying a market rate. The ability of the Federal Reserve intelligently to set money targets and control the transaction monetary aggregate requires that we minimize as far as possible the blurring between transaction and investment balances. Such blurring is, of course, always there and it has been exacerbated by the NOW account and similar "other checkable deposits." However, a true market rate NOW account would make it extremely difficult to distinguish transaction from investment balances. At least for the time being, the needs of monetary policy suggest to me that we must limit the transaction characteristics of a new instrument--through some reasonably short maturity or notice provision--recognizing that the account will not be as attractive as desired vis-a-vis money funds, but also recognizing that depository institutions offer insurance and more convenience than money funds.

I do not mean to be negative, but rather to share with you my concerns. We are perhaps at the stage when the question about a competitive account is not "if" but "when," but we are also at the stage when "what" must consider costs and the needs of monetary policy.

I hope that you can soon share with me your additional suggestions as to account design, as well as comment on my concerns with your proposal. I do not relish designing an account in Washington and I would appreciate any further suggestions you could present.

Sincerely,

Paul A Volcker

The CHAIRMAN. Mr. McCormick, let me just say—and I just want to make my position clear—I certainly don't intend to take the limited time we have to debate the provisions of S. 1720 today. But you quote what I said a month ago. That is what I have said from the very beginning and what I continue to say. My position has not changed at all.

Even if I wanted to dictate a solution, that's not possible. There are 14 other members of this committee, there is a House Banking Committee, there happen to be 99 other Senators and 435 Congressmen. So, even if I wanted to, I simply could not accomplish that.

From the very beginning, when I introduced S. 1720, I announced that we would move to a markup when it was practical to do so, that there is no point in going to a markup, even if I could get something through it, if it has no chance of becoming law.

So, the statement you quote is no different from my position from the very beginning and should be no surprise to anyone, whether it happens to be part of this or whether it does not. But I have wanted it for a long time, because of the urgency of the situation that I feel is developing in this noncompetitive situation with the nonfinancial-type institutions getting in the financial services industry.

So, I just wanted to clarify that. That is correct, I did say that to your people, and it's something I've said since last May in the hearings. But I've also said that when there is a general consensus, then I will push for a markup, and when there is reasonable hope of getting something done.

My only disappointment, I suppose, and what I was saying earlier, is that I wish I saw some other alternative or some other way—and here I'm not speaking about the specifics of S. 1720 at all, I just don't see it possible to maintain the status quo or to go backward. I wish I could.

As I have outlined to you many times, personally and publicly, my background and my feelings about the small independent banks, my feelings representing a small State, about concentrations of power in the big boys, I just think we have to face the real world and get together and say, "What is it going to look like 5 or 10 years down the road?" It makes no personal difference to me as an individual. I don't own any bank stocks, savings and loan stocks. I don't own any stock at all. With seven children and two houses, I can't afford any stock in anything.

So, the ups or downs of bankers or savings and loans have no impact on me, personally, at all. I just see a growing problem in this revolution occurring. I just wish there was some way that we could get people not to take hard positions in opposition, but to recognize that there are some middle ground on all of these issues, even on due on sale at the realtors. There are some middle grounds that we can reach and help an industry, a whole industry, to survive, not compartmentalizing it into this segment of industry and that segment of industry, while Sears and Merrill Lynch roll merrily along just sucking up those funds like a big giant vacuum cleaner. Maybe that's how Sears got into it, they've sold vacuum cleaners. [Laughter.]

And they're going to run a giant one around this country, sucking up all the money out of our small savings banks.

Mr. Gunderson, arguing that capital assistance is not needed, do you assume, then, that there are enough potential merger partners to solve the problem?

Mr. GUNDERSON. It's our feeling that with the regulators' bill, as you have proposed, that this would meet the needs of the regulators in dealing with the problems. As we indicated though, we don't oppose the capital assistance bill, but we do have some questions in our mind whether there really is a legitimate need for it with the expanded powers of the regulators under the other proposal.

The CHAIRMAN. Since Congress has imposed liability and asset restrictions on thrifts, shouldn't Congress establish some of the outlines for capital assistance. The U.S. Savings & Loan League testified earlier that they want restrictions on the ability of the regulators to alter the assistance. In essence, what I think you're saying is that if we don't establish some guidelines. The regulators go on in the framework we are now. We're giving them virtually a blank check to do whatever they want. We are certainly not supervising or overseeing the mergers as they're taking place now.

Do you feel by not doing that, if it isn't needed, that we're simply giving too much flexibility to the regulators?

Mr. GUNDERSON. That's one of those difficult areas. There's always discussion on how much is too much as far as the regulators. But I'd like you to recognize these are unusual times, and unfortunate times, and they have to have some flexibility if they're going to deal with these situations.

COMPETITIVE INSTRUMENTS FOR DEPOSITORY INSTITUTIONS

The CHAIRMAN. Mr. McCormick, you argue very clearly and forcefully that depositiory institutions ought to have competitive instruments, and I agree. I haven't been happy with a lot of things that DIDC has done.

It would be very easy for commercial banks to say, "All right. Here's an instrument that pays competitive market rates, has insurance on it, and can instantly be competitive with money market funds, probably more competitive."

I would anticipate that with insurance and traditional depository services that you could be 2 or 3 percent below the money market funds and still be very competitive. The reason that that can't be a quick and easy solution is the problem of the thrifts if we grant that that type of an instrument solves the problems of commercial banks rather quickly as far as the competitive situation. But doesn't it just increase the cost of money with the thrifts and commercial banks that have large portfolios of mortgages, the cost of money goes up and they're still tied down with 6, 7, 8, 9 percent mortgages?

Mr. MCCORMICK. Yes; it does. And as a matter of fact, for most banks, it would be a very expensive and difficult thing to do. Although I think most banks would continue in the black, the banks would lose anywhere from one-half to three-quarters of their present profits if you deregulated the liabilities the way we request.

However, if you don't deregulate us, we'll eventually be cornered out of the market, which is slowly but surely taking place.

So, our problem, as managers in a free enterprise system, will be to figure out how to pay competitive rates for that money and then operate our institution in such a way to compensate for those costs and still operate at a profit. Many of us have already begun to do that. I would be very surprised if you hadn't received some correspondence from some folks who are wondering what banks are doing raising service charges and special fees which they're coming up with.

Well, one of the things we're doing is trying to figure out how to pay the interest rates we have to pay in order to compete in the marketplace for those instruments we can't compete on now. And we will need to do more of that if we've got the opportunity to compete.

The CHAIRMAN. We have to educate the people. I get some letters from a lot of people that want 5 percent, 30-year mortgages, but they want to earn 15 percent on their savings.

Mr. McCORMICK. I talk to a lot of people like that.

The CHAIRMAN. They don't seem to understand the correlation there. They want to pay little interest and receive a great amount.

So, I don't know the answer to your question there, how to educate them on that.

But the point is that I don't know how we phase out deposit regulation controls on the liability side, particularly for thrifts, if we don't also deregulate the asset side. That's the problem. I don't know how we deregulate one without the other. The phase out of interest rate controls which is underway is appropriate.

But there's got to be some solution to that asset side, particularly for the thrifts and those banks who are heavily engaged in long-term mortgage credit.

ELIMINATION OF ACQUISITION AUTHORITY

Mr. McCormick, also in your testimony, you propose eliminating the extraordinary acquisition authority of the FDIC. And as far as the regulators' bill, S. 2532, you propose that we amend the capital assistance bill, as was done in the House, to include commercial banks at a higher net worth level than the thrifts.

So, what I am wondering, isn't there some inconsistency in your statement? On the one hand, you are proposing including commercial banks in the regulators' bill because they are aren't failing. On the other side, you want them covered in the capital assistance bill because some of them may.

Mr. McCORMICK. The point is that the very large banks, which are the banks that normally would be involved in mergers across State lines under the extraordinary acquisitions section, are not banks that are heavily engaged in mortgage lending and that are having a difficult time because of the present interest rate structures. So, we don't see any reason why they should have to be included.

On the other hand, the proposal that we are making is to give banks an opportunity that apparently the framers of the legislation thought they were giving them, in that banks would participate in it if they qualified.

The difference is that no bank is allowed to have 2 percent net worth. Long before you get to 2 percent, the regulators would have taken various actions forcing you into increasing your capital.

In my own bank, for an example, my capital had dropped to 6 percent a couple of years ago. After about a 4- or 5-month struggle with the regulators, I had to raise $1 million and put it into my bank.

So, our position was that since the bill with regard to thrifts proposed that when their net worth dropped to 1 percent below the standard they would begin to receive assistance, if they were otherwise qualified, you should do the same thing regarding banks if you actually want banks to participate. Otherwise, no bank would ever participate, because there will never be a bank at the 2-percent level.

The CHAIRMAN. I understand your point. But why does it harm anything to have banks included in the regulators' bill if they never need it. Why not have it in place?

You see, that was one of the major objections that I had to the House-passed bill, which, as I said yesterday, is sunsetted in September. That is one of the reasons I saw no great rush to pass it last December. It's sunsetted in September of this year. It still does. So, we passed that for 3 months. Big deal.

It seems to me if you're going to have a regulators' bill, it ought to be permanent and in place in case you need it. If you don't, it isn't used.

Certainly, to have such a high threshold, $2 billion, ignored a lot of people who potentially get in trouble and who need mergers, and to exclude commercial banks didn't make any sense even though most of them were not in trouble, but not being able to foresee economic conditions in the future, again why not have an emergency bill in place.

Those were the main objections that I felt were fatal flaws in the House bill. What is the objection to including commercial banks, even though they are not in the same trouble as thrifts, for that eventuality? If it doesn't occur, why does it hurt to have it in there?

Mr. McCORMICK. First of all, you would find our association in agreement with you, if you write a bill that in other respects has the same terms as the House-passed bill, that it probably should be, if not necessarily permanent legislation, at least legislation with a much longer life than 1 or 2 years.

We feel that way because, of course, we don't want to have to go back through the legislative process every couple of years or, in this case, for example, in September.

The problem, otherwise, is this: One of the basic positions of our association is that we are opposed to mergers in general, and when you have a problem there are a number of ways in which you can try to solve that problem. It looks like the major way that we have seen is to merge institutions very aggressively. So, we think that practice should be discouraged, and we ought to find other ways to solve the distressing economic problems that the thrift industry and some banks face. It is an extension of that position that we didn't want commercial banks included in the regulators' bill. To do so would, in our opinion, breach the Douglas amendment of the

Bank Holding Company Act. Now, if Congress determines that bankholding companies should be able to acquire banks across State lines, that is something that should be determined explicitly and we should slug it out in the legislative arena. But to breach the Douglas amendment through the back door by throwing banks into this bill when we are not aware of any banks that really need to be involved, we think, weakens the Bank Holding Company Act unnecessarily, and that is the reason why we oppose it.

The CHAIRMAN. Mr. Gunderson, do you have any closing comments you wish to make?

Mr. GUNDERSON. We agree with you as far as the lowering of the threshold of the size, if the regulators say they need it, Mr. Chairman. Although we don't view it as likely, that there would be any major bank that would fail, we do feel that in case of some extraordinary event, it is well to have that provision in place. So we don't feel that we have given up anything really in having banks a part of it. In fact, we feel there is some benefit in it.

The CHAIRMAN. Well, I would say to both of you, I wish none of this were necessary.

Mr. GUNDERSON. Don't we all, Mr. Chairman.

The CHAIRMAN. I wish Congress would get its act together and quit playing games with the economy and focus on doing something about the interest rates without regard to whether people are Republicans, Democrats, liberals or conservatives.

So, I wish we were not considering emergency legislation of any kind. Inasmuch as it appears necessary, I hope we can get together and come to a consensus between the House and the Senate and do something within the next month or so to try and alleviate the short-term situation.

Again, I can't stress enough my experience in this body, which is not that long, 7½ years, but we are so good at passing short-term emergency pieces of legislation without taking the longer viewpoint. That is basically what I am trying to get us to do.

Fine, we will address the short term, but why can't for once we look at it longer term, look at 1985 and 1990, to try to smooth out some of these ups and downs.

Mr. McCormick, I have one question given to me that Senator Proxmire would like me to ask. I understand the ABA's position is as follows: give thrifts 5 percent commercial loan power now; eliminate the statutory authority for the differential; when regulation Q is eliminated completely, give thrifts 10 percent commercial loan powers; over 10 percent commercial loan powers can only be exercised by an institution with a bank charter.

First of all, I suppose I should ask Mr. Gunderson if that is the ABA's position?

Mr. GUNDERSON. Yes; it is, Mr. Chairman.

The CHAIRMAN. And the question to you from Senator Proxmire: Would the IBAA agree with this position?

Mr. McCORMICK. No, sir, we would not. We have now taken that position before our policymaking bodies on, I believe, three occasions, and on each occasion they have rejected that position. Our position is that it would be a mistake to create two commercial bankin[illegible] side by side in the United States with different [illegible] rules, and different standards.

We would be interested in talking about some kind of legislation that would facilitate the conversion of thrift institutions to commercial banks if that is necessary. But thrifts must be on a level playing field with us, and we don't think that is possible in two separate systems.

OTHER ASSET POWERS

The CHAIRMAN. Let me ask you this question. In my analysis of a lot of your membership, independent banks who have very large portfolios of mortgage credit, in some case as large as their thrift competitors, they are profitable. Can't we assume that that is because they have other asset powers, even though they are primarily acting like a thrift in the percentage of their assets through mortgages?

Mr. MCCORMICK. I think you can assume, to the extent that they are more profitable than the thrifts, it is the result of having done other things with their money than to just be in the mortgage business. [Laughter.]

The CHAIRMAN. That is exactly my point. The last nominee we had for the Federal Home Loan Bank Board came from a State-chartered institution in Texas, where they have asset powers. I don't know to what extent. I don't know whether they have 100 percent or what, but he testified that last year they were profitable. They were a thrift that was profitable. They made money—and he is the only one I have had around here lately that said that—and that although they had commercial powers, that 83 percent of their assets were still in mortgages.

So, I can't agree with you that I think because they are granted 5, 10, and maybe 15 percent asset powers that that turns them into a commercial bank; that they still wouldn't have the vast majority of their assets in mortgage lending. I would agree with you, if they want to get out of that business and become a commercial bank, then they should apply for a charter.

But I don't see that the small amounts in the compromise that the ABA and U.S. Savings and Loan League are talking about—I would certainly understand why you would oppose 100 percent or 50 percent or very large amounts that, in effect, would turn them into a commercial bank without going through the process of becoming one. But I really don't understand the fear of your organization of this 5, 10, 15 percent, the ABA's position.

Mr. MCCORMICK. First of all, many of our banks don't use commercial banking powers to any greater extent than you were describing. So, when you give thrifts 15 or 20 percent commercial banking powers, you are putting them on the same footing as many of our banks in the way they operate, because they are basically hometown banks; they perform the whole range of financial services in their towns including mortgage lending, consumer lending and other functions.

So, what looks like to you a very limited authority looks like full authority to us in many cases.

The other problem we have is simply the "nose under the tent" theory. Once you start we don't feel you can stop it. I think some-

thing else needs to be added. We are not aware that there was ever really any compromise that anybody has agreed to.

I may be talking out of school as far as the ABA is concerned, but it is my understanding that the U.S. League has never agreed to the other side of the proposed compromise. A document that is presently being floated around the Hill indicates that by 1986 the thrifts would have 100 percent commercial banking powers, and there is the implication that this is what they want and that they are still working in that direction.

That is a long way away from what the American Bankers Association indicated they might be willing to do. So, I don't see any real progress being made.

The CHAIRMAN. Let me ask you of another hypothetical situation. Suppose the worst possible thing happened from your position and all the thrifts turned into commercial banks and they were all competing with you? I am not sure that that is as much competition as Sears and all the people we have discussed before.

In other words, in my State, as an example, we have had a lot of new banks spring up in the last few years, new banks in competition with each other. In my own particular neighborhood a savings and loan turned into a bank, if that is any additional competition from a new bank starting up.

Again, I have to emphasize, where I feel the concentrations are coming and your real competition will be in the future is from these vast conglomerates that are getting into the financial services industry. I feel you have a preoccupation with competition, with the sick and dying thrift industry, and even if they survive, even if many of them did become much like commercial banks and your worst fears were realized, I can't help but think that that is less competition for you than this other side.

That is why I have a difficult time understanding it. In normal times, fine. Commercial banks, thrifts fight each other, give away teapots and glasses and all those things. Competitive wars go on. I understand all that. But there is such a changed market situation today.

Mr. GUNDERSON. Mr. Chairman, may I comment? I am president of an approximately $25 million bank in a small community in northwestern Wisconsin, and I guess in my heart of hearts I am not overjoyed of the fact that thrifts are getting commercial powers. Yet at the same time, as I look into the future for my community bank, as we work to plan its future, hopefully in a successful manner, I recognize that the only way we are going to remain viable and profitable and serve that community is if we do get some more powers on our asset side, as we move in to compete with the Sears, Roebucks and all the others that you mentioned. And if this is what it takes, I feel that, you know, I am certainly willing to go along with it, as was, in our case, our community bankers division and advisory group in this case, who represent community banks under $100 million in our association.

So, we just have to have the ability to compete and get new powers if I am going to continue to serve that community of 1,600 people in northwestern Wisconsin.

Mr. MCCORMICK. Chairman Garn, we don't see that the asset powers in S. 1720 are worth the tradeoff. We need to get more com-

petitive powers. We need to have the opportunity to compete in our marketplace, but giving commercial banking powers to thrifts is not a reasonable tradeoff, based on the powers that we see in S. 1720. That is the reason why we will not go for the compromise.

The CHAIRMAN. I understand that, but let me ask you, if you were president of a thrift, of a savings and loan, rather than being president of your bank, what do you think your position would be in a sick and dying industry like that?

Mr. McCORMICK. If I were the president of a savings and loan, my position would be just exactly the opposite of what it is. [Laughter.]

That is just a person's vested interest of trying to get out of a difficult situation.

The CHAIRMAN. I understand that. That is one of the things that troubles me, that a whole industry is being changed, not by actions of this committee or Jake Garn, but by market forces. It isn't the way it was 25 or 30 years ago. If I could be a dictator, I would put it all back, neatly compartmentalized. Believe me, I would. My life would be so much simpler. [Laughter.]

Everybody in their place doing their own thing, and it would be so nice. Then I would dictate, but I can't do that. And one thing that bothers me is the lack of concern, apparent lack of concern for some of your friends. I am sure you have got a lot of friends who runs savings and loans. The independent bankers can say, "Fine, we don't like it." I understand that.

Lee just testified he doesn't like it. He would prefer—he is a small banker; he would prefer not to give them any powers. I would, too. I just don't understand what appears to me to be a blind attitude that "We are all right; we think we will weather through." Sometimes I think, from some of the letters I get, there are some of your members who simply hope they will die, that that really helps them. Out of the way. Let them fail. Don't help them, and then we will do better in our own community.

Mr. McCORMICK. I can't speak for every one of our members, but we are concerned about the thrift industry. We would like the thrift industry to survive as a thrift industry. It is one of the reasons why we strongly supported the legislation on the House side. We don't want to go back to 25 years ago. Many of our institutions are very modern and aggressive in the manner in which they serve their markets, and I think that it is a misrepresentation that we are just flat against any change and that we are against doing anything for the thrift industry.

You mentioned earler a Texas savings and loan that was operating at a profit and you said they still had 83 percent of their assets in mortgages. I would submit to you that if you would go look at that institution you would discover that they are in an economic climate where people are borrowing money at 17 and 18 percent, and so they have some mortgage business to do. In most markets you don't have anybody in those high-rate mortgages because nobody can afford to pay them.

The CHAIRMAN. Well, that question was asked. He didn't feel that was the reason that they were staying profitable.

Bob, I don't mean to represent all organizations when I say "blind opposition." There are a lot of letters being generated from

some place. The statements are too similar. They are obviously not individually written, and they do express blind opposition to any change. You have not done that today. You have not done that with me personally or in any meetings we have been in, but the volume of mail that I am starting to get now does do that.

So, from whatever source that is coming, it is not my opinion or representation; it is a matter of what they are saying in their letters. I just wish we could have more cooperative attitudes, some means of drawing us together, because I think 4 or 5 years down the road, if something is not done, there is going to be a lot of people who look back with hindsight and say, "What a mistake we made."

Mr. Telling, of Sears, is accomplishing what he says he intends to accomplish, and others in this industry. I think we are only seeing the tip of the iceberg with new types of financial institutions. I think they will grow even more rapidly unless we are able to have a little foresight and look to the future.

But I don't mean to belabor the point. We do have another witness unless either one of you have any other comments?

Mr. GUNDERSON. Mr. Chairman, if I could just make one closing statement? As a part of our written testimony that we submitted in our consensus statement, we also urge additional powers for regulated financial institutions, over and above those outlined in S. 1720. We feel that these are very important if we are to move ahead and compete in this new era. And, as we pledged to you when we testified on S. 1720, we have tried very conscientiously to remove some of the differences and some of the problems.

We have not reached agreement with the U.S. League. But we have talked to IBAA and all the other associations. We would certainly hope that as you move ahead in this legislation that we have testified on today, that expanded powers for financial institutions could be a part of it and it could be marked up. And we will get behind it and work with you, provided it meets some of the criteria that we have set out.

We feel that we have come a ways on it, maybe not as far as some would like us to, but we need to have a little give on the other side, too, to get some of these things worked out.

The CHAIRMAN. Obviously, there will never be specific agreement on everything in a particular bill by all sides. That is where ultimately we have to sit down and go to a markup. I don't expect that and never anticipated that.

Mr. MCCORMICK. Mr. Chairman, I want to reiterate that if we got all of the provisions of S. 1720 I don't believe our banks could compete with Sears in our marketplace doing the business that we should be doing for our community, and that is the point.

I will say this: If we saw anything coming down the road which would allow us to compete effectively with money market mutual funds in our marketplace, I would be happy to take that thrift powers question back to our association for reconsideration.

The CHAIRMAN. Thank you very much, gentlemen. We will have some additional questions, not only from me but other members of the committee, for your response in writing. We appreciate your time and your willingness to testify today. Thank you.

May I invite to the witness table Mr. Andrew Carron. Mr. Carron is a senior fellow at the Brookings Institution. Mr. Carron, we are happy to have you with us today. If you would like to proceed?

STATEMENT OF ANDREW CARRON, SENIOR FELLOW, BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. CARRON. Thank you, Mr. Chairman. The list of witnesses for the session this morning has promoted me. I am currently a research associate at Brookings, although I have been appointed a senior fellow effective July 1. So I will take that in stride.

I am pleased to accept your invitation to appear today and discuss the current problems of the Nation's savings institutions and the housing industry. I have been analyzing these subjects intensively for the past 1½ years. Many of the results of my study were published by Brookings earlier this year in a book, "The Plight of the Thrift Institutions."

My testimony today will draw on the material contained in the book, as well as an additional research since the book went to press. My prepared testimony contains three parts: the circumstances leading up the situation we have today; the outlook for the thrift industry in 1982, 1983, and beyond; and my comments on the legislation proposed for addressing the problems.

In the interest of brevity, and acknowledging the committee's deep awareness of the industry's history, I shall focus on the latter two topics now.

LOSSES LARGER THAN ANTICIPATED

As part of my research I have constructed a computer model to forecast earnings and the financial condition of the thrift industry. The results showed that structural changes will be required. A sizeable minority of savings and loan associations will never return to profitability on their own, even under optimistic economic assumptions. A much smaller number of mutual savings banks will be similarly affected.

I found that more than 400 firms, mostly small and inefficient, but with ample resources, must find merger partners to avoid potentially irreversible losses of net worth. Still others, at least 200 and possibly as many as 600, under adverse economic circumstances may require financial assistance from the deposit insurance agencies to arrange mergers.

My recent analyses conducted since the book went to press have indicated larger losses for 1982 and 1983 than I had anticipated earlier, but the number of firms affected has remained relatively constant.

Indeed, in his prepared testimony yesterday, Chairman Pratt reported on new forecasts by his agency. Consistent with my earlier estimates, he said that 227 to 558 associations would reach zero net worth by the end of next year, depending on interest rates. So it should be noted that the fundamental results remain the same regardless of the assumptions.

Small differences in numbers of institutions affected and the amounts of required assistance do not change the policy recommen-

dations. That is largely because the damage from regulation and high interest rates has already been done.

It should be apparent, therefore, that the evolution of the industry over the next few years has been largely predetermined and only the accounting rules that emphasize historical costs have prevented a widespread realization of this fact. Because of the losses which have already been incurred, many firms simply will not survive unassisted.

Turning now to the cash flow situation, this is one potentially troubling factor that has only recently come to light. Last year depositors withdrew nearly $40 billion more than they put into these institutions. In the first quarter of this year outflow has continued at a $21 billion seasonally adjusted annual rate.

And I just received the savings and loan activity report for the month of April. And for the savings and loan industry alone there was a net outflow of $5.2 billion in just the month of April. Now, a large part of this is seasonal due to income tax payments, but the Bank Board estimated that perhaps half of this was not seasonal, and that suggests that this outflow is continuing, only slightly abated from the tremendous rate that was experienced last year.

"QUIET RUN"

The regulatory agencies call this the "quiet run." Over the near term, institutions can adapt by curtailing their new lending, leaving it to other sectors to provide funds for housing. For the future, however, the "quiet run" poses two dangers. One is the possibility that it will turn into an all-out run on the thrift institutions. I do not expect this to happen.

The other concern is that the "quiet run" will continue, slowly draining the resources of the thrift industry. At the time that I wrote my book this did not appear to be likely, and I did not think any new policy was required. But now, with more data available, I feel that the liquidity problem is one that must be addressed.

But even if deposit inflows are restored, the role of the thrift institutions in the mortgage market will change. Housing finance will not be as abundant or as cheap as it was in the past, but the larger and more diversified thrift institutions that do survive will continue as major sources of mortgage credit.

Expertise in originating and servicing mortgage loans is a major asset of the thrift industry and one it is likely to exploit. New sources of lending and retail banking will move in to preserve service and competition if the thrifts fail to do so.

Turning now to the policy options, the major issue, as I see it, is how to manage this transition. Left alone, most problem thrift institutions would arrange voluntary mergers. Many, however, would ultimately fail, requiring the deposit insurance agencies to pay off account holders. This process would take place over a period of years. At the discretion of the regulators, action could be taken sooner to arrange mergers or liquidations, and this could be less costly.

But all assistance plans are not equally efficient in solving the transition problems of the thrift industry. Meeting the goal of effi-

cient and effective policy will depend on supplying sufficient aid to the firms that require it and withholding it from those that do not.

The issues as I see them are as follows: first, to decide whether a consolidation of the thrift industry is desirable, or even avoidable, given the cost of preserving the existing structure; and, second, to select a set of programs to achieve the preferred outcomes.

Required assistance to the thrift industry will be reflected in a significant impact on the budget regardless of what policies are chosen. Assisted mergers will require substantial, although manageable, expenditures for the next several years. Preservation of the industry, with its current structure, would necessitate even larger subsidies.

The existence of many small firms does provide opportunities for local control and specialized attention to local needs. The drawback, however, is operating inefficiency. With increased homogenization of financial markets and institutions and with depositors becoming more aware of alternative uses for their savings, the specialized local thrift institution is less viable than in the past.

Turning now to the notion of providing capital assistance to institutions, this principle of injecting capital into ailing but viable institutions is a good one. The FSLIC is already using income capital certificates in a program to supply resources to institutions. Such plans are intended to give an institution time to work out problems on its own and to give the FSLIC time to arrange a merger should that become necessary.

Since the program operates as an exchange of notes, there is no immediate budget impact. The cost of assistance is reflected in the interest payments to the savings and loan on the FSLIC's note. Although such a plan vests great discretion with the regulatory agency, it does help provide a cost-effective solution to the short-term problems.

I want to read a couple of paragraphs from the concluding chapter of my book. I wrote: "The programs in place today will prove adequate to address the problem only if there is some improvement in economic conditions that retards the pace and reduces the level of thrift industry losses.

"The most urgent change needed in current policy is an improvement in the powers and resources of the FSLIC. Ideally, the agency would develop a comprehensive program to subsidize, merge, or sell off those few hundred associations that are virtually certain to require assistance. It should proceed rapidly with such a plan, thereby ending the erosion of firms' assets, minimizing market uncertainty, and preserving public confidence in the agency's ability to protect depositors."

Mr. Chairman, the legislation before this committee today, together with the Bank Board's assisted merger program, represents precisely the sort of plan that I envisioned when I wrote those words.

S. 2531 provides tangible assistance that will improve the earnings and net worth of troubled institutions. It maintains incentives for sound business decisions by providing only partial coverage of losses. It provides time for institutions to regain a sound footing at a modest cost. It does not require counterproductive investment be-

havior and steers clear of the day-to-day operations that are properly outside the purview of the Federal Government.

It permits the regulatory agencies to modify the assistance programs to suit changing economic circumstances, while not setting an arbitrary cutoff date, and it allows the necessary process of industry consolidation to go forward in an orderly fashion.

This plan envisions the issuance of substantial amounts of securities, particularly by FSLIC. Although this process does not involve an expenditure of the resources in the insurance fund, it does encumber the assets there. The agency may be limited in the amount of paper it can issue, and therefore, also in the amount of assistance provided, by the total amount of resources available to it.

CAPITAL ASSISTANCE COULD EXCEED RESOURCES

There are circumstances under which the costs of assisted mergers and capital assistance could exceed the available resources. Such an eventuality would not occur for at least a year, but the committee may wish to consider addressing the problem now.

I have suggested that there are a number of ways of doing this. One is through a direct expenditure, but it is not necessary to do it that way. Another possibility would be to increase the agency's borrowing authority at the Treasury. Alternatively, and preferably in my view, the obligations of the insurance agencies could be made explicit obligations of the Federal Government.

This would serve a dual purpose. It would provide the necessary financial backing for agency notes, and it would reassure depositors that their savings are, indeed, protected.

The thrift institutions' problems derive in large part from the preponderance of a single type of instrument in their asset portfolios, the long-term fixed-rate residential mortgate. Regulations and tax law precluded institutions from doing much else.

The expanded asset powers permitted by the Monetary Control Act and those proposed in subsequent legislation, such as S. 1720, are intended to reduce the balance sheet vulnerability of thrift institutions and to foster equality among financial institutions. The new powers are vital to the future health of the thrifts that survive the current transition problems.

Although expanded asset powers are not a panacea for today's ills, they should be considered now as part of a plan to revive and restructure the thrift industry rather than forcing institutions to make unprofitable investments. Moreover, to the extent that new powers can reduce the costs of assistance, they will have a favorable impact on the budget.

The principal means used so far to address the problems of the thrift industry has been merger. Even if S. 2531 were to pass, the need for substantial numbers of mergers would not be eliminated.

The bill, correctly, does not seek to forestall the necessary process of consolidation. Indeed, the companion regulators bill provides useful guidance on mergers to the regulatory agencies, clarifying policy in the area. These policies, if properly executed, will reduce the administrative and financial burden on the agencies, thereby cutting budgetary expenditures as well.

In conclusion, the thrift industry has begun a major restructuring. This process has required government intervention, and additional assistance will inevitably be necessary, but the appropriate tools have now been forged and honed. It only remains to put them to use. I encourage the committee to proceed with the three elements now before it: short-term assistance, regulatory flexibility, and expanded asset powers. Thus equipped, the regulatory agencies can provide a bulwark against which a revitalized thrift industry will be built.

Thank you, Mr. Chairman.

[The complete statement follows:]

Statement of

Andrew S. Carron

Research Associate
Economic Studies Program
The Brookings Institution
Washington, D.C.

Prepared for delivery before the

Committee on Banking, Housing and Urban Affairs

U.S. Senate

May 27, 1982

Mr. Chairman, my name is Andrew S. Carron. I am a research associate in the Economic Studies Program at the Brookings Institution. The views expressed here are mine alone, and should not be ascribed to the trustees, officers, or other staff members of the Brookings Institution.

I am pleased to accept your invitation to appear today and discuss the current problems of the nation's savings institutions and the housing industry. I have been analyzing these subjects intensively for the past year and a half. Many of the results of my study were published by Brookings earlier this year in a book, The Plight of the Thrift Institutions. My testimony today will draw on the material contained in the book, as well as on additional research conducted since the book went to press.

I would like to divide my testimony into three parts: the circumstances leading up to the situation we have today; the outlook for the thrift industry in 1982, 1983, and beyond; and my comments on the legislation proposed for addressing the problems.

Background

Thrift institutions grew and prospered under a regulatory framework that led them to specialize in long-term fixed-rate mortgage lending and short-term deposit taking. The system functioned smoothly as long as interest rates remained steady. Deposit rate ceilings were imposed in the mid-1960s to restrain the cost of funds to institutions as market interest rates began to rise.

The thrift industry, despite periodic setbacks, gave the appearance of health during most of the 1970s. Assets of the more than 5,000 savings and loan associations and mutual savings banks tripled over the decade, exceeding $800 billion in 1980. The thrift institutions were the major source of new funds for housing during this period.

The ratio of net worth to assets of the thrift industry--a measure of long-term viability--fell continuously during the 1970s, however, indicating difficult times to follow. Deposit rates, which affect the cost of an institution's liabilities, were gradually becoming more sensitive to market changes as the result of administrative and legislative deregulation. The introduction of the six-month money market certificate in mid-1978 is an important case in point. Rates of

return on the asset portfolios of thrift institutions remained locked into earlier lower levels by the long-term nature of mortgages and by regulations limiting investment diversification. The authority to write variable-rate mortgages on a nationwide basis, for example, did not come about until several years after the liability side of the balance sheet was largely deregulated. When interest rates rose to record levels in 1980 and 1981, deposit flows and mortgage lending slowed, the cost of funds rose sharply, and profits turned negative.

During 1981, the savings and loan associations lost $4.9 billion, their first loss in recent history. The mutual savings banks lost $1.5 billion last year following a smaller loss in 1980. Net worth declined sharply and the thrift industry began sliding toward insolvency. In March, the savings and loan industry's net worth fell below 4 percent of assets.

It should be stressed that this trend is a long-term problem of profitability and viability, and does not affect the routine operation of individual firms. Customers will continue to receive normal deposit and lending services throughout the period of adjustment. Liquidity—the availability of cash to meet normal business needs—has not been a problem for the thrift industry as a whole. Potential cash shortages have been avoided through a reduction in new lending and through increased borrowing. In the case of the savings and loan industry, most of that borrowing has come from the Federal Home Loan Bank System.

Outlook

As part of my research, I constructed a computer model to forecast the earnings and financial condition of the thrift industry. The results showed that structural changes will be required.

Earnings. A sizable minority of savings and loan associations will never return to profitability on their own, even under optimistic economic assumptions. A much smaller number of mutual savings banks will be similarly affected.

In my book, I calculated the performance of the industry under three sets of assumptions, which I labelled "optimistic," "consensus," and "pessimistic." Under each set of assumptions, interest rates recede from their 1981 levels, the only difference being the speed of decline. I also incorporated fairly generous assumptions about mortgage turnover, sales of "all savers" certificates, and deposit growth. These were all based on expectations at the time my book went to press last fall. I found that more than 400 firms--mostly small and inefficient, but with ample resources--must find merger partners to avoid potentially irreversible losses of net worth. Still others--at least 200, and possibly more than 600 under adverse economic conditions--may require financial assistance from the deposit insurance agencies to arrange mergers. A few closings and liquidations may occur.

Not only has the path of the economy followed the "pessimistic" scenario since my book went to press, but the industry has not fared well with respect to mortgages, certificates, or deposits either. My recent analyses have indicated larger losses for 1982 and 1983 than I had anticipated earlier, but the number of firms affected has remained relatively constant. Indeed, in his prepared testimony yesterday, Chairman Pratt reported on new forecasts by his agency. Consistent with my earlier estimates, he said that 227 to 558 associations would reach zero net worth by the end of next year, depending on interest rates.

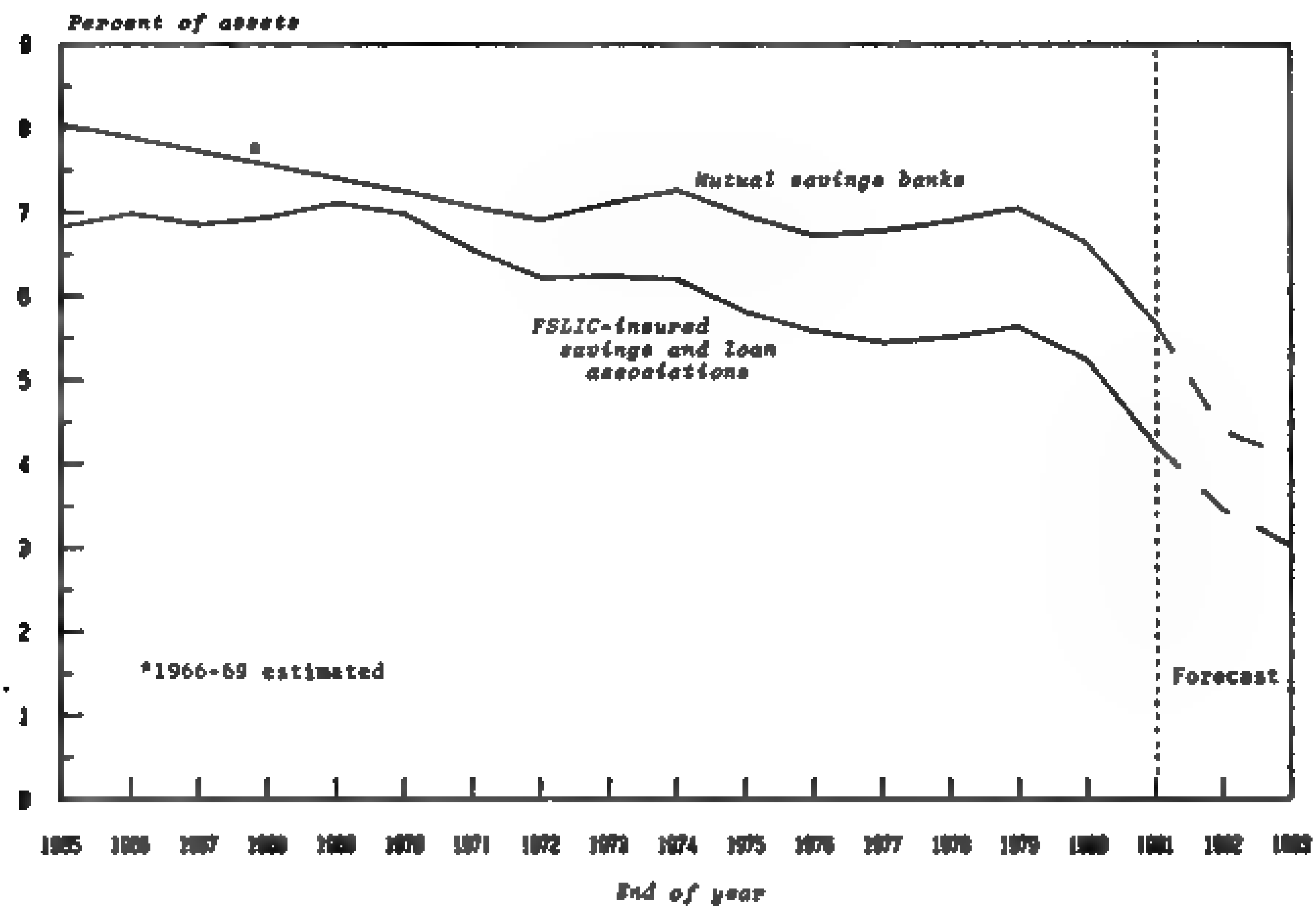
It should be noted that the fundamental results remain the same regardless of the assumptions; small differences in numbers of institutions affected and required assistance do not change the policy recommendations. That is largely because the damage from regulation and high interest rates has already been done (Figure 1).

It should be apparent that the evolution of the industry over the next few years has been largely predetermined, and only the accounting rules that emphasize historical costs have prevented a widespread realization of this fact. Because of the losses which have already been incurred, many firms simply will not survive unassisted.

Cash flow. One potentially troubling factor that has only recently come to light is the increased flow of deposits out of thrift institutions. Last year, depositors withdrew nearly $40 billion more than they put into these institutions. In the first quarter of this

FIGURE 1

THRIFT INDUSTRY NET WORTH



year, outflows continued at a [illegible] billion seasonally adjusted annual rate (Figure 1).

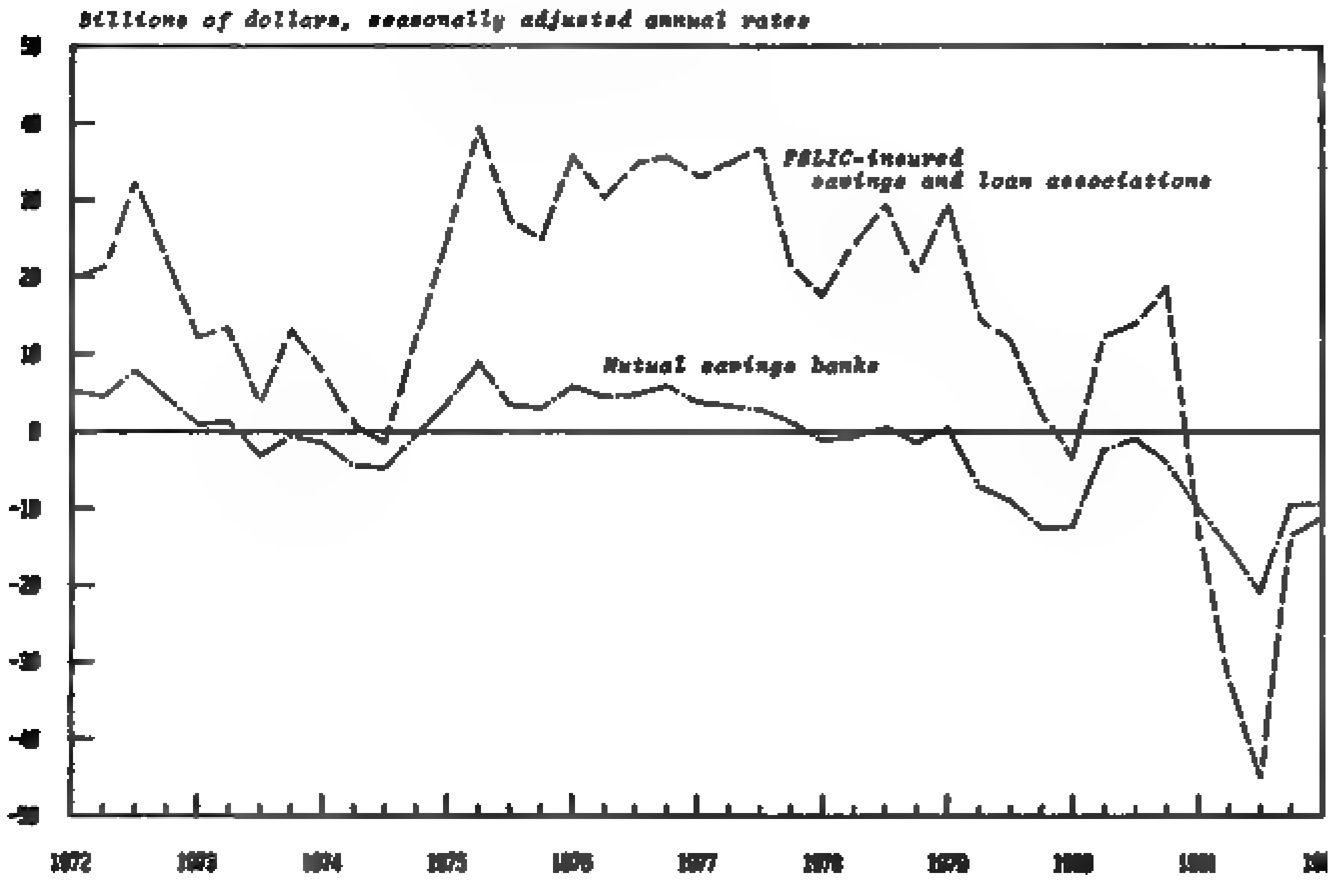
Deposit flows have fallen at times in the past, as individuals sought higher interest rates outside the regulated banking and thrift sectors. The concern now is that people appear to be shifting money into commercial banks, sometimes accepting a lower interest rate to do so. After correcting for interest rate differentials and other relevant factors, the data indicate that one-third of the deposit outflows in the current episode represent shifts from thrifts to banks. The only plausible explanation is that some people now believe banks are safe and thrifts are not. The regulatory agencies call this the "quiet run."

The thrift industry cannot sustain this rate of losses indefinitely. Over the near term, the institutions can adapt by curtailing their new lending, leaving it to other sectors to provide funds for housing. Once the principal source of housing funds, the thrifts now trail commercial banks.

For the future, however, the "quiet run" poses two dangers: One is the possibility that it will turn into an all-out run on the thrift institutions. While I do not expect this to happen, such a run would create havoc in financial markets, demolish the hope of a stable monetary policy, and inflict serious damage on the national economy. The other concern is that the "quiet run" will continue, slowly draining the resources of the thrift industry. At the time I wrote my

FIGURE 2

NET NEW SAVINGS RECEIVED



hand, this did not appear to be likely, and I did not think any new policy was required. Now, with more data available, I feel that the liquidity problem is one that must be addressed.

Even if deposit inflows are sustained however, the role of thrift institutions in the mortgage market will change. Housing finance will not be as abundant or as cheap as it was in the past, but the larger and more diversified thrift institutions that survive will continue as major sources of mortgage credit. Expertise in originating and servicing mortgage loans is a major asset of the thrift industry and one it is likely to exploit. New sources of lending and retail banking will move in to preserve service and competition if the thrifts fail to do so.

Policies

The major issue is how to manage the transition. Left alone, most problem thrift institutions would arrange voluntary mergers; many would ultimately fail, requiring the deposit insurance agencies to pay off account holders. This process would take place over several years. At the discretion of the regulators, action could be taken sooner to arrange mergers or liquidations, and this could be less costly. The FSLIC has also begun a limited assistance program through the use of income capital certificates Other policy instruments have been and will be used to prop up the industry, principally the "all savers" certificate and deposit rate ceilings. All of these plans share the common ingredient necessary for success: they include a subsidy to

offset the losses incurred by failing institutions on their old low-rate mortgages.

This subsidy is not a "bailout," or at least not a new one. The decision to assist failing institutions was made when Congress created deposit insurance; economic circumstances then put the institutions in an untenable position. (Although the insurance applies to depositors, not institutions, it is usually cheaper and less disruptive to channel the assistance through an institution. The law requires the FSLIC and FDIC to find the least costly alternative.) But the assistance plans are not equally efficient in solving the transition problems of the thrift industry. Some involve budgetary expenditures far greater than the amounts indicated above. Meeting the goal of efficient and effective policy will depend on supplying sufficient aid to the firms that require it and withholding it from those that do not.

The issues, as I see them, are as follows: first, to decide whether a consolidation of the thrift industry is desirable or avoidable, given the costs of preserving the existing structure; and second, to select a set of programs to achieve the preferred outcomes. Whatever the ultimate decisions are, they must incorporate compensation--a subsidy--for thrift institutions or their insured depositors. So another consideration is who will pay for the accrued burden of losses, since the institutions cannot.

Required assistance to the thrift industry will be reflected in a significant impact on the budget regardless of what policies are chosen. Assisted mergers will require substantial--although manageable--expenditures for the next several years. Preservation of the industry with its current structure would necessitate even larger subsidies. The existence of many small firms does provide opportunities for local control and specialized attention to local needs. The drawback, however, is operating inefficiency. With increased homogenization of financial markets and institutions, and with depositors becoming more aware of alternative uses for their savings, the specialized local thrift institution is less viable than in the past.

Capital assistance. The principal of injecting capital into ailing but viable institutions is a good one. The FSLIC is already using income capital certificates in a program to supply resources to institutions. Along with the assistance come stringent operating requirements. Such plans are intended to give an institution time to work out problems on its own, and to give the FSLIC time to arrange a merger should that become necessary. Since the program operates as an exchange of notes, there is no immediate budget impact. The cost of assistance is reflected in the interest payments to the savings and loan on FSLIC's note. Although such a plan vests great discretion with the regulatory agency, it does help provide a cost-effective solution to the short-term problems.

In my book on the thrift industry, I wrote as follows:

> The programs in place today will prove adequate to address the problem only if there is some improvement in economic conditions that retards the pace and reduces the level of thrift industry losses. . . .
>
> The most urgent change needed in current policy is a improvement in the powers and resources of the FSLIC. Ideally, the agency would develop a comprehensive program to subsidize, merge, or sell off those few hundred associations that are virtually certain to require assistance. It should proceed rapidly with such a plan, thereby ending the erosion of firms' assets, minimizing market uncertainty, and preserving public confidence in the agency's ability to protect depositors. . . .

The legislation before this Committee today, together with the Bank Board's assisted merger program, represents precisely the sort of plan I envisioned when I wrote those words.

S. 2531 provides tangible assistance that will improve the earnings and net worth of troubled institutions. It maintains incentives for sound business decisions by providing only partial coverage of losses. It provides time for institutions to regain a sound footing, at a modest cost. It does not require counterproductive investment behavior and steers clear of the day-to-day operations that are properly outside the purview of the federal government. It permits the regulatory agencies to modify the assistance program to suit changing economic circumstances, while not setting an arbitrary cutoff date. And it allows the necessary process of industry consolidation to go forward in an orderly fashion.

This also entails the issuance of substantial amounts of securities, particularly by the FSLIC. Although this process does not involve an expenditure of the resources in the insurance fund, it does encumber the assets there. The agency may be limited in the amount of paper it can issue—and therefore also in the amount of assistance provided—by the total amount of resources available to it. These resources are composed of the unencumbered assets of the fund plus the borrowing authority at the Treasury. There are circumstances under which the costs of assisted mergers and capital assistance could exceed the available resources. Such an eventuality would not occur for at least a year, but the Committee may wish to consider addressing the problem now.

Resource enhancement. Potential difficulties could be avoided by increasing the resources available to the insurance agencies. This could be done through a direct appropriation, but it is not necessary to do so. Another possibility would be to increase the agencies' borrowing authority at the Treasury; probably only the FSLIC would require an increase, as it has the largest obligations and only a $750 million line of credit.

Alternatively—and preferably—the obligations of the insurance agencies could be made explicit obligations of the federal government. This would serve a dual purpose: it would provide the necessary financial backing for agency notes, and it would reassure depositors that their savings are indeed protected.

There would be no budgetary impact to either an extension of full faith and credit or to increased budgetary authority, unless and until expenditures were made. But since it is universally acknowledged that the insurance obligations would be met in any and all circumstances, there would certainly be no additional impact on the budget from either policy. Moreover, by reassuring depositors, liquidity would be improved, lessening the burden on the regulatory agencies.

Income assistance. In conjunction with capital assistance, some depository institutions may require a short-term subsidy to permit them to become viable over the long run. Where this assistance would be less costly than merger or liquidation, both in terms of direct outlays and social costs, it is highly advisable. S. 2532 provides an important and overdue clarification of the FDIC's powers to provide such assistance.

Asset powers. The thrift institutions' problems derive in large part from the preponderance of a single type of instrument in their asset portfolios--the long-term fixed-rate residential mortgage. Regulations and tax law precluded institutions from doing much else. The expanded asset powers permitted by the Depository Institutions Deregulation and Monetary Control Act of 1980 and those proposed in subsequent legislation are intended to reduce the balance sheet vulnerability of thrift institutions and to foster equality among financial institutions. The new powers are vital to the future health of thrifts that survive the current transition problems. Although

expanded asset powers are not a panacea for today's ills, they should be considered now as part of a plan to revive and restructure the thrift industry, rather than forcing institutions to make unprofitable investments. Moreover, to the extent that new powers can reduce the costs of assistance, they will have a favorable impact on the budget.

Mergers. The principal means used so far to address the problems of the thrift industry has been merger. Many depository institutions have expressed a strong desire to extend their area of operation, including expansion across state lines which has traditionally been prohibited. Such market extensions provide profit opportunities and competitive advantages through economies of scale and scope. The FSLIC has approved a number of interstate mergers for troubled savings and loan associations. Approval of an interstate or cross-industry merger may be likened to a license that can be offered for sale. In effect, the FSLIC is selling market entry rights for its own benefit. The price of the license is the excess of liabilities over assets for a failing thrift, a price that would have to be paid by the insurance agency if the license is not sold. (The merger approvals have often included a small amount of financial assistance from the FSLIC.) Even if S. 2531 were to pass, the need for substantial numbers of mergers would not be eliminated. The bill correctly does not seek to forestall the necessary process of consolidation. Indeed, S. 2532 provides useful guidance on mergers to the regulatory agencies, clarifying policy in the area. This policy, if properly executed, will reduce the

administrative and financial burden on the agencies, thereby cutting budgetary expenditures as well.

Conclusion

The thrift industry has begun a major restructuring. This process has required government intervention, and additional assistance will inevitably be necessary. But the appropriate tools have now been forged and honed; it only remains to put them to use. I encourage the Committee to proceed with the three elements now before it: short-term assistance, regulatory flexibility, and expanded asset powers. Thus equipped, the regulatory agencies can provide the bulwark against which a revitalized thrift industry will be built.

The savings institutions of the future will compete in an unregulated environment, and that is as it should be. They should neither be burdened with onerous restrictions nor given special advantages. In this context, the government's role should be seen as temporary, intended to facilitate a transition. This participation should be limited in scope and brief in time. The transition program should embody as few regulations and as many market incentives as possible. The alternative, putting these firms in a sheltered environment until they recover, would only ensure their eventual demise.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Carron. S. 2531 authorizes the FSLIC to provide partial capital assistance for troubled institutions; whereas, the House bill, that has been discussed many times in the last few days, would maintain all thrifts at a 2-percent net worth level.

In your view, what would be the short- and long-range impacts of those two programs, either the capital assistance or the capital maintenance?

Mr. CARRON. Mr. Chairman, I am troubled by a program that proposes to make up virtually any and all losses that might be incurred by an institution. It not only creates perverse incentives to incur the losses in the first place, but it also discourages the institution from restructuring its operations, reducing its operating expenses, and becoming profitable again, because once the institution becomes profitable further subsidies are cut off and it must begin to repay subsidies it has received so far. Thus, the incentive structure is inappropriate.

Further, such a plan is unable to distinguish between those institutions which do have prospects for viability over the long run and those which do not, if large losses incurred by nonviable institutions are made up to the same level as small losses by well managed, growing, aggressive institutions.

Finally, there is the point that was made by Chairman Pratt in his testimony yesterday; namely, that if all institutions were to be held at a 2-percent level for some period of 2 to 3 years and then the program were to stop, all those institutions would begin moving en masse toward zero net worth. That would create an unmanageable burden on the regulatory agencies.

NET WORTH GUARANTEE

Looking at the particular way that the House bill is structured, as a net worth guarantee rather than a capital infusion such as S. 2531, those net worth guarantees would not provide any sort of earnings assistance to the institution. It would not change their fundamental health. It doesn't provide any tangible sort of assistance. Whereas, the legislation that you have introduced provides net worth in the form of paper, but the paper earns interest, which typically has been paid in cash to the institution. So it helps net worth and it helps earnings in a tangible fashion.

The CHAIRMAN. Having looked at the problems of the thrift industry for the last year or so, if you were a thrift manager, what would you do in today's environment to increase earnings, cut costs, and restructure yourself to preserve your position in the financial market?

Mr. CARRON. I think that a large part of the problem is that the thrift managers, thrift presidents, have grown up in an environment over the last 50 years where the Government has told them what they could pay on their deposits, what deposits they could offer, what they could do with their assets, to some extent what they could charge on their loans. So this has created an environment in which ordinary business decisions are relegated to Government agencies, and the initiatives and incentives that would ordinarily apply have not been there.

The major problem, as I see it, for savings and loan and mutual savings bank executives is to get out of this old mindset and begin to make sound business decisions, the rational investment choices that are necessary. I don't think that there is any single solution, no special type of investment that they ought to use or particular instruments. But if you just look at some of the characteristics of the industry, many savings and loans are very small institutions. They have a very high-operating cost. Some of these institutions have operating expenses which exceed 2 percent of assets. In today's environment you just cannot survive when you exceed 2 percent of assets in operating costs.

The largest savings and loans, such as the big associations in California, have operating costs below half a percent of assets. So perhaps consolidation is one way to get operating costs down, and just being somewhat more attentive to the costs involved in day-to-day operations.

I have a chart in my book that traces the pattern of operating costs over time: Those operating costs dropped every year up until 1966, and they have risen every year since 1966, and I am sure that the significance of that year is not lost on you. That is the year that the Government came in to the thrifts and said, "We are going to hold down what you have to pay on your deposits."

And being a competitive industry, they had to find some other way to compete, so they competed on the basis of service and longer hours and more branches and more personnel and more lavish facilities, and so forth. And, indeed, operating inefficiency crept in.

So they really have to begin operating as good businessmen and women and get out of this pattern, this role, that has been dictated to them for the past 50 years.

The CHAIRMAN. You have indicated that the new asset powers are vital to the future health of the thrifts to survive the current transition problems. If new powers are not provided, do you believe the thrift industry can survive in the long term?

Mr. CARRON. I think that some number of institutions which have savings and loan, or saving bank charters will be able to survive, but as an industry that has a role, that has a focus, that plays a major part in the economy, no, it cannot survive.

PRECONDITION FOR ASSISTANCE

The CHAIRMAN. The House bill includes a precondition for assistance, with a requirement that an institution have reasonable prospects for long-term viability. What does that mean to you?

Mr. CARRON. To me that means a relief act for lawyers and economists, and perhaps I am going against my self interest in saying this. It opens up the possibility that the very first time an institution is denied assistance under that provision it would go to court and there would have to be some sort of judicial interpretation of what the measure is, what the demarcation line is that determines whether you have a prospect of long-term viability or not.

So, one of two things happens: either you have a series of court cases or administrative proceedings that involve many lawyers at high daily rates and may expert witnesses or, alternatively, the

Bank Board simply throws up its hands and says, "We know we don't have a chance on this one; we are just going to give assistance to everyone."

So that particular provision, being very serious about it, would have no impact whether or not it is in the bill.

The CHAIRMAN. Well, we are very good at lawyers' relief acts in this body, and I suppose that is because the majority of the Members of both the House and Senate are lawyers, and if they create enough confusion while they are here, then they can be paid highly to interpret what they did after they get on the outside.

But this seems to me far, far broader than what we usually do, just so wide open and such a broad provision that I don't know how you could possibly interpret; "have reasonable prospects for long-term viability" with no definition whatsoever. It seems to me it would open up such a complete can of worms of confusion that, I think you are right, it would simply say, "Well, we have got to say everybody has long-term viability whom we assist."

From what you have indicated today, it would certainly be clear to me that long-term viability is really directly related to the thrifts being able to get additional, more flexible asset powers. Is that a fair summation of what you have said?

Mr. CARRON. I think you have to look at this as a package.

There is the long-term viability, which, as you very correctly pointed out, lies in expanded asset powers and, I might point out, further expansion of liability powers which will come about after 1986 when all the controls have been removed on rates and accounts.

There is also a transition that must be gone through to get from where we are today to that long run. The regulators bill and the capital assistance plan are the elements that go to the transition. So, no one of those elements make sense without the others.

The CHAIRMAN. Thank you very much, Mr. Carron. I would suggest that the hearings of the last 2 days have been very profitable. I appreciate all of the witnesses over these many hours. I certainly believe there is general support for capital assistance in the committee, and that is not prejudging the exact form that will come out, but certainly general support for a capital assistance program.

I personally believe that capital assistance rather than capital maintenance is the most effective manner of stabilizing the financial condition of thrifts. In addition to capital assistance, I believe the regulators bill should be passed to provide additional flexibility to the insuring agencies.

During these hearings, although they have focused on capital assistance and on the regulators bill, the witnesses have provided important support for the process of fashioning effective legislative solutions to the current problems of the thrifts, as well as a discussion of the longer term problems.

What also has come through in the testimony is the need to act now to broaden the asset powers of thrifts. The phaseout of deposit controls began almost 4 years ago with the development of money market deposit certificates. Two years ago Congress put its stamp of approval in H.R. 4986 on the phaseout that had already begun in the marketplace. What must be done now, in my opinion, is to provide relief on the asset side of the balance sheet.

We are now beginning this process of what is now temporary relief, but I believe it can turn into a long-term illness and only become worse.

After the recess and review of the hearing record, in addition to the additional questions the witnesses will provide for the record in writing, I do intend to conduct a committee markup on capital assistance, a regulators bill, and whatever powers on which we can reach agreement.

I thank all of you very much. The committee is adjourned.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

[Additional material received for the record follows:]

Statement of

[illegible]
Executive Vice President
[illegible] Corporation

[illegible]
[illegible]
[illegible] Corporation
and
[illegible]
Executive Vice President
[illegible], Inc.

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate
May [illegible], 1982

Mr. Chairman, we appreciate the opportunity to present testimony on S. [illegible], the proposed "Capital Assistance Act of 1982" on behalf of the deposit insurance and guaranty facilities created under state laws in Pennsylvania, Maryland, North Carolina, Massachusetts and Ohio. Deposit insurance funds in these states insure some [illegible] thrift institutions having total deposits of approximately $[illegible] billion and serving some [illegible] savers.

Each of the deposit insurance funds which we represent was created by act of a state legislature and is operated as a not-for-profit corporation. The financial institutions we insure are thrift institutions – savings and loan associations, mutual savings banks and cooperative banks – which are chartered, examined and regulated by the state financial institutions supervisors in our respective states.

State funds have come into existence for a variety of reasons. For example, the fund in Pennsylvania primarily serves institutions too small to qualify for Federal insurance. In Massachusetts, where the state's deposit insurance funds predated the FSLIC and the FDIC and served as a model for the Federal deposit insurance programs,

st Massachusetts thrifts have chosen to maintain their historic association with the te funds. But while each fund has its own history and reason for existance, as a group state deposit insurance facilities have two common characteristics:

1. On average, the institutions which they insure have better earnings than do thrift institutions nationally.
2. Furthermore, the deposit insurance funds themselves have strong reserves and generally have higher reserve to deposit ratios than their Federal deposit insurance counterparts.

State insured institutions are nonetheless suffering from the same difficulties ch are causing concern for Federal regulators and the Congress, and in some cases our e funds are already providing assistance to member institutions. One might ask why, state funds are presently dealing adequately with the problem of state insured itutions, we are today appearing to request access to the capital assistance horized by Senator Garn's bill for the financial institutions which we insure. To erstand the position of the state insurance funds on this issue, one must examine, t, the rationale for the Garn bill and, second, the way in which the Garn bill changes nature of our deposit insurance system.

Rationale for a Capital Assistance Program

The unprecedented increase in interest rates which has occured over the last few rs as a result of discordant Federal fiscal and monetary policies has wreaked havoc n the earnings of even the best run thrift institutions. As this Committee well knows, leral housing policies such as FHA guarantees for fixed rate mortgages, bad debt erves transfers provided under the Internal Revenue Code, and a Federally sponsored ondary market which for many years was tied to fixed rate mortgages have all ongly encouraged thrift institutions, whether federally insured or not, to make long-m fixed rate loans. Institutions, committed by Federal policy to making fixed rate

mortgages, can only sustain profits for so long in the face of unrelenting inflation and an ever rising cost of funds.

What the Garn bill does is to recognize that, during the period necessary to put our Nation's fiscal and monetary policies on a more responsible course, it makes sense to sustain those thrift institutions which are well managed and have the potential to operate profitably when interest rates once again reflect more moderate inflationary expectations. The Garn bill also will have the effect of sustaining public confidence in the safety and soundness of depository institutions by reducing the likelihood of a series of bank closings which might otherwise undermine the stability of our Nation's financial system.

A New Federal Policy

The Garn bill and its counterpart in the House of Representatives, the St Germain bill, seek to provide temporary assistance to thrift institutions by infusions of capital which will bolster the net worth or capital accounts of assisted institutions. The agencies which are to serve as conduits for such assistance under both bills are the Federal deposit insurance agencies.

The Garn and St Germain bills differ in several important respects. The Garn bill provides a formula which may be used to determine the amount of assistance which a financial institution will receive. Also, the Garn bill on its face looks to the accumulated reserves of the Federal deposit insurance funds as the source for payment on capital certificates in the event an assisted institution should be liquidated, whereas the St Germain bill has the Treasury Department provide a Net Worth Guarantee Account to back up guarantees of net worth issued to assisted institutions.

It must be recognized, however, that both bills represent a significant change in Federal policy. Until this time, Federal policy has relied on a deposit insurance program to safeguard depositors' funds. This deposit insurance program has been funded by the premiums paid by insured institutions, not by taxpayers' dollars.

Both the Garn and St Germain bills would dramatically alter the Federal role in protecting depositors and stabilizing financial institutions by authorizing extensive use of paper capital infusions. The depositor protection provided by Congress in the 1930's was based on insurance principles – a pooling of the risk of default on deposits and the payment of premiums by insured institutions in amounts sufficient to cover the risk of loss. The paper capital infusion program represents a new Federal initiative for the protection of depositor funds which, in addition to the reserves of the insurance funds, effectively pledges taxpayer dollars to that end.

Essentially, the Federal government through the Treasury (in the St Germain bill) or the Federal deposit insurance funds (in the Garn bill) will be authorized to create multi-billion dollar contingent liabilities, and the responsibility of the Federal taxpayer to stand behind these liabilities is clear. Just two months ago the Congress passed H. Con. Res. 290 reaffirming that deposits in federally insured depository institutions are backed by the full faith and credit of the United States. In authorizing the insurance agencies whose reserves insure deposits to issue capital certificates secured by those same reserves, the Garn bill in fact extends the same assurance of full faith and credit backing to capital certificates. Of course, to do otherwise would be a serious mistake. If Federal deposit insurance agency paper in the form of income capital certificates were allowed to default, the Federal government's own credit rating and that of dozens of Federal agencies would also be very adversely affected.

As authority to create multi-billion dollar contingent liabilities is granted to the FDIC and the FSLIC and it is recognized that the back-up for these liabilities must ultimately be the Federal taxpayer, not the premium-funded reserves of the Federal insurance funds, then it must also be recognized that a new Federal policy has emerged. This policy is a policy of capital assistance in addition to deposit insurance.

What is explicit in the St Germain bill and implicit in the Garn bill is clear nonetheless -- the Federal deposit insurance agencies are for the first time to become the conduits for billions of dollars of Federal capital assistance to financial institutions....not the sources of such assistance.

The St Germain bill clearly recognizes that the FDIC and FSLIC will no longer play a deposit insurance role only using premium funded reserves, but instead will be playing a new capital assistance role using the Federal taxpayer's credit. Eligibility for capital assistance under the St Germain bill is thus made available on the same basis to all institutions regardless of the source of their deposit insurance. We believe that the Garn bill should take the same approach.

Why State Insured Institutions Should Be Covered

The rationale for the Garn bill applies with equal force, we believe, to Federally and non-Federally insured institutions. Earnings at both types of institutions have been eroded by discordant Federal fiscal and monetary policies and by Federal budget deficits which have kept interest rates at historically unprecedented levels. Both types of institutions have the prospect of long range profitability in a more stable financial environment. And capital assistance which allows state-insured institutions to avoid closure will help to maintain public confidence in all financial institutions.

The one argument which we have heard against extending capital assistance to state-insured institutions is voiced by Chairman Isaac of the FDIC. He has stated that Federal assistance to non-Federally insured institutions is "unacceptable because these banks did not wish to abide by Federal regulations, did not wish to be examined by a Federal agency and did not wish to pay Federal deposit insurance premiums. I responded that I admired their independence and spirit but could not reconcile their position with their request for assistance from the very Federal agencies they had chosen to eschew." (Letter from William M. Isaac to Honorable Fernand J. St Germain, May 17, 1982)

The points Mr. Isaac makes deserve to be addressed, and we would urge this mmittee to consider the following:

- First, state insured institutions are not immune to Federal regulation. There is little question that, under the supremacy clause of Article VI of the Constitution, the United States may assert its authority over the activities of state-chartered banks, whether state-insured or not. Indeed, the extent of Federal regulation of the financial activities of these institutions is broad and in recent years has become broader. For example, state-insured institutions are subject to the sweep of a battery of Federal consumer protection laws—the Truth in Lending Act, the Real Estate Settlement Procedures Act (RESPA), the Equal Credit Opportunity Act, the Election Funds Transfer Act and many other statues have been applied to these institutions. And, perhaps most importantly, in 1980 the Congress did not hesitate to subject these institutions to the requirement that they maintain non-earning reserves at the Federal Reserve under the 1980 Monetary Control Act (Public Law 96-221).1/

- Second, these institutions are not unregulated. They are chartered, regularly examined, and very ably regulated by banking supervisors in their respective states. Their deposits are insured by state-created insurance funds which are supervised by state banking authorities. The lack of an additional layer of Federal regulation has not made these institutions any less safe or sound - indeed, as a group, they have better earnings and perhaps stronger reserves than their Federally regulated counterparts.

Note: Institutions insured by the Massachusetts deposit insurance funds have been subjected by Congress to "Regulation Q" ceilings and Federal consumer regulations as well.

- Finally, we do not believe that Federal regulation – or any regulation – should be viewed as a good in itself. If Federal regulation is needed, it should be imposed, and where it is not needed it should not be required. To impose Federal regulation for its own sake when state regulation has proven to be adequate seems to run directly contrary to the philosophy of deregulation and transfer of authority to the states which have been enunciated by the Reagan Administration and many members of this distinguished Committee. And to deny access to the capital assistance program simply because state-insured institutions are not subject to regulation by the Federal deposit insurance agencies seems to us to be unjustified.

Indemnification

But Mr. Isaac does, we think, make a point which, in the context of the Garn bill, must be addressed. While the Garn bill creates a new capital assistance program by granting authority for the Federal deposit insurance agencies to create an unspecified amount of contingent liabilities for the Federal taxpayer, this bill, unlike the St Germain bill, appears to comtemplate that the first call to satisfy these contingent liabilities will be on the reserves of the deposit insurance funds themselves. If this is the case, Mr. Isaac may properly ask what contribution state-insured institutions will make.

Of course, if the Federal deposit insurance funds should be exhausted, state insured institutions and their depositors, as Federal taxpayers, would have to stand behind the income capital certificates issued by the Federal insurance agencies. But in addition, it seems only fair to require indemnification of a Federal deposit insurance agency for any expenditures from its reserves which may be made to redeem income capital certificates which have been issued to a state-insured financial institution which is liquidated.

Thus, we are prepared to accept, as a condition for access of state-insured institutions to any capital assistance program, a requirement that state deposit insurance funds shall be liable for losses on income capital certificates issued by the Federal

agencies to state-insured institutions to the same extent as the Federal deposit insurance funds are liable for losses on income capital certificates issued to Federally-insured institutions. If the St Germain approach is ultimately adopted by the Congress, it would appear that the Federal deposit insurance funds would not be liable to cover losses, and the state deposit insurance funds should be similarly treated. But if the Garn approach is adopted, we are prepared to step up to our responsibilities to the same extent as the Federal deposit insurance funds.

We would recommend that, for the sake of administrative convenience, all state-insured thrifts be required to apply to the FSLIC for income capital certificates. Since all of these institutions are thrifts, the FSLIC would be more familiar with their problems than the FDIC, and to have separate sets of regulations and procedures for assisting state-insured institutions adopted by both FSLIC and the FDIC seems a waste of time. We note that while mutual savings banks are insured by both the FDIC and the FSLIC at the Federal level, there is no reason why state-insured savings banks should not for administrative convenience be required to apply to the FSLIC for income capital certificates. Of course, under the Garn bill, the FSLIC would receive an indemnification pledge from the state fund.

One might then ask, "If the Garn bill passes and you must indemnify the Federal insurance funds, why not issue your own income capital certificates?" The answer is quite simple:

- First, the income capital certificates authorized by the Garn bill will have the implicit full faith and credit of the U.S. government behind them. Neither our state funds nor the state legislatures which created them can offer guarantees which have the backing of the highest and best credit rating available – that of the U.S. Government. Only the Congress can commit the Federal credit rating to capital certificates which will be ultimately backed by the taxpayers of this country – including our insured banks and their depositors.

- Second, the Garn bill declares as a matter of law that income capital certificates shall constitute net worth and further declares that institutions holding such certificates may continue operations notwithstanding any contrary "provisions of the constitution or the laws, civil or criminal, of any State, express or implied." We do not have authority to legislate such conditions.

Conclusion

We are not happy to have to be here asking for inclusion of state-insured institutions in the Garn bill. Indeed, we hope that the money market conditions which have rendered the Garn bill necessary will change in time to eliminate the need for any issuance of income capital certificates. None of the institutions which we insure want to be in a position where they will need to apply for income capital certificates. But if the Garn safety net is necessary, it should be in place. Perhaps there should be a sunset provision, limiting the duration of the authority contained in the Garn bill to a specified period of time - so that the Federal government can get out of the net worth guarantee business when it is no longer needed. But certainly if the Garn bill is needed, there is no reason why it should not be made available to all financial institutions without regard to the source of their deposit insurance.

The institutions we insure pay deposit insurance premiums as do the institutions insured by Federal deposit insurance agencies. The deposit insurance funds we run are operated on sound insurance principles. The problem addressed by the Garn bill is not a deposit insurance problem; it is a systemic problem created by Federal monetary and fiscal policies. The Garn bill recognizes the responsibility of the Federal government to address this problem. We only urge, Mr. Chairman, that as this Committee marks up S2531, the "Capital Assistance Act of 1982", you consider the welfare of all financial institutions and their depositors.

This testimony is presented on behalf of:

Cooperative Central Bank (Massachusetts)

Maryland Savings Share Insurance Corporation

Mutual Savings Central Fund, Inc. (Massachusetts)

North Carolina Savings Guarantee Corporation

Ohio Deposit Guaranty Corporation

Pennsylvania Savings Association Insurance Corporation

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

May 26, 1982

Honorable Jake Garn
Chairman
Committee on Banking, Housing and
Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your invitation to comment on S. 2531, the "Capital Assistance Act of 1982" and S. 2532, a revised version of the "Regulator's Bill". Thank you for contacting me on this matter as I appreciate the opportunity to provide the views of the National Credit Union Administration.

S. 2531 would permit the FSLIC and the FDIC to purchase capital instruments from qualified institutions whose net worth is at or below 3%. It clarifies that these institutions may issue such instruments and that their purchase will in fact be classified as net worth. Qualified institutions consist of banks or savings and loan associations which have at least 20% of their assets in residential mortgages or mortgage backed securities, have a net worth of 3% or below, have incurred losses during the previous two quarters, and are able to remain solvent for at least 6 months.

This legislation is designed to assist institutions with extensive portfolios of long-term fixed-rate mortgages whose cost of funds is presently exceeding their yield. Primarily, these institutions are savings and loan associations, mutual savings banks, and to a lesser extent national banks. This legislation will provide certain needed additional flexibility to the regulators of these institutions and I am most supportive of your efforts to enact this legislation.

Further, I see no necessity to include credit unions in this legislation. Federal credit unions were only recently granted long term mortgage authority under the conditions of P.L. 95-22. Also, they have the capability to structure variable rate type loans for their members. As a result, there are only a very few credit unions which could qualify under the terms of this bill. Additionally, the agency has the flexibility under Sec. 208 of the Federal Credit Union Act (12 U.S.C. 1788) to provide the type of assistance to credit unions which best meets their needs consistent with the operation of the National Credit Union Share Insurance Fund. Therefore, I am recommending that no changes be made to your bill to include credit unions.

With respect to S. 2532, the revised Regulators Bill, the National Credit Union Administration continues its support for this additional regulatory flexibility. The revision makes no changes to the credit union provisions and I

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NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

have reviewed and have no objection to those changes requested by the other financial regulators. As you know, the credit union provisions consist of (1) a provision to permit our Share Insurance Fund to borrow from our Central Liquidity Facility and (2) expanded emergency authority with respect to credit union mergers and with respect to purchase and assumption by other federally insured institutions. For the record, both of these provisions are contained in S. 1720 in support of which I testified on October 30, 1981.

I hope these comments are of assistance.

Sincerely,

E. F. Callahan

E. F. CALLAHAN
Chairman

SAVINGS BANKS ASSOCIATION OF NEW YORK STATE

200 PARK AVENUE NEW YORK, N.Y. 10017 AREA CODE 212 [illegible]

OFFICE OF THE CHAIRMAN

June 4, 1982

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
5121 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

We strongly support and applaud your efforts to develop a consensus that will enable you to mark-up a banking bill before the July recess. Its constituent elements will be drawn from measures which provide capital assistance for needy institutions, increased authority for regulators, and broadened powers for S&L's and savings banks. We support all these proposals in general and hope for their immediate enactment.

The priorities which we assign to the elements of the package are obvious -- short-term assistance comes before long-term expansion of asset powers. We hasten to add, however, that we desperately need the authority <u>and</u> the time to implement the authority to offer the broadest possible range of banking services prior to the dismantling of Regulation "Q".

Following are several specific comments:

1. <u>Capital Assistance</u>
   We favor the Annunzio Amendment, which would preclude agreements to merge and change management as conditions for assistance.

2. <u>FDI Act Section 13c</u>
   This authority, as amended should be used. In view of Chairman Isaac's many public statements, Committee Report language should be clear if a statutory mandate is not possible. Assistance should be given at a 3 percent or higher level of net worth before a merger is necessary.

3. Inter-industry, Interstate Takeovers
These are acceptable only on a basis of inter-industry reciprocity. Interstate, inter-industry takeovers should be limited to institutions with $2 billion or more in assets.

4. "Pre-supervisory Mergers"
This concept, which involves capital assistance and a flexible section 13c, is a crucial step toward recovery by Congress of its rightful role in the re-structuring of the banking industry.

5. Federal Pre-emption of State Prohibitions of Stock Conversions
New York State mutuals have lost capital accumulated over a century or more of positive growth rates. The need for flexibility in accessing the capital market is acute.

6. Federal Pre-emption of State Alternative Franchise Taxes
These taxes fly in the face of the fundamental principal of equity in taxation based upon ability to pay. Our need is especially great in these times of negative earnings.

7. Federal Charters for Mutual Savings Banks
We need the option of choosing between a meaningful FDIC - FHLBB indemnification agreement and FDIC insurance for Federal Mutual Savings Banks.

8. Due-on-Sale
This is an essential ingredient in any program designed to facilitate the re-structuring of a bank's mortgage portfolio.

We wish to close with the following caveat. Considerable attention is being paid today to the necessity of putting the regulated industries in a postion of competitive equality with the unregulated sector of the money market. We should not, however, be deluded in thinking that this objective can be achieved simply by some form of liability de-regulation. It can only be achieved by total de-regulation of the asset-side, the only condition which will assure regulated institutions the wherewithal to compete in a world without Regulation "Q". To de-regulate the liability side too soon is to invite self-destruction, clearly a development which would tend to maximize -- hardly minimize -- the potential cost to the insuring agencies.

We offer these comments in the hope that they will be of use in addressing the pressing problems which threaten our industries today.

Sincerely yours,

William F. Olson

Westport, N.Y., 12993
November 9, 1981

Hon. Jake Garn,
Chairman,
Committee on Banking, Housing, and Urban Affairs,
United States Senate,
5300 Dirksen Senate Office Building,
Washington, D.C.

Dear Mr. Chairman:

I enclose a copy of my "Comment on Dr. Austin's Article, 'The Evolution of Commercial Bank Merger Antitrust Law'", in which I discussed the legislative history of the Bank Merger Act of 1960 and the Bank Merger Act Amendments and the Bank Holding Company Act Amendments of 1966. I think this Comment might be helpful to your Committee in connection with its consideration of your bills, S. 1720 and S. 1721, and other proposals to revise the laws relating to mergers and bank holding company acquisitions of commercial banks and other financial institutions, and similar proposals concerning the relations between various financial institutions.

As my Comment makes clear, I am convinced that the Congress has never voted to impose the stringent standards of the 1950 amendment to section 7 of the Clayton Act to mergers of commercial banks approved by the bank supervisory agencies. In particular, the Congress has refused to apply to bank mergers the rule that the benefits of a proposed merger are irrelevant and may not be considered and weighed against the loss of competition which might result from the merger. When the Supreme Court, in the Philadelphia National Bank case, applied this rule, on the basis of its holding that the 1950 amendment to section 7 applied to bank mergers, the Congress responded by amending the Bank Merger Act to provide that a bank merger could be approved if its anticompetitive effects are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served. The new standards were to be applied by the courts in any antitrust action against the merger, except one under section 2 of the Sherman Act, instead of the previously applicable standards of the antitrust laws. To make clear its disapproval of the Philadelphia National Bank holding for the banking world, the Congress made a similar change in the Bank Holding Company Act provisions for acquisitions, which had clearly been subject to the 1950 amendment to section 7 of the Clayton Act.

These amendments to the Bank Merger Act and the Bank Holding Company Act were strongly opposed by the Antitrust Division and Senator Hart of Michigan, but Senator Hart's motion to strike this provision from the Bank Holding Company Act Amendments bill was overwhelmingly defeated.

A second respect in which the Congress did not think the standards of the 1950 amendment to section 7 of the Clayton Act should apply to bank mergers was the strict application of the "line of commerce" rule. By holding that the line of commerce involved in the Philadelphia National Bank case, and subsequent cases, the courts and the Antitrust Division have taken the position that no consideration should be given to competition from other financial institutions, such as savings banks, savings and loan associations and credit unions, in deciding the competitive effects of a merger.

The Antitrust Division and the courts have been enthusiastic, and unrealistic, in refusing to consider the pressure of competition from these other institutions, even though the competition is becoming greater, and the thrifts are seeking to acquire virtually all powers of commercial banks.

I believe the decision of the Congress in 1950, 1960 and 1966 that bank mergers and bank holding company acquisitions should not be considered under the strict standards of the 1950 amendment to section 7 of the Clayton Act, under which the benefits of a proposed merger to the community to be served were irrelevant, were based on two factors.

First, the banking system, operating under the money power as well as the Commerce Clause, was providing most of the nation's money supply in the form of demand deposits; it was providing the principal payment mechanism for government, industry, and the public; and it was providing a major, if not the principal, supply of funds for loans to the government, industry, and the public. Clearly the consequences of failures and breakdowns in the banking system were far more serious than failures or breakdowns in other parts of industry.

Second, and as a result of the first factor, the government has taken an active role in the creation, supervision, regulation, and protection of commercial banks since the Constitution was ratified. It is only necessary to mention the first and second Banks of the United States, the National Currency Act of 1863 and the National Bank Act of 1864, the Federal Reserve Act of 1913, and the acts establishing the FDIC in 1933 and 1934, to make it clear that the commercial banking system is different from any other industry, however important the other industries may be.

For all practical purposes, it is impossible to establish a commercial bank, to establish a branch of a commercial bank, or to merge a commercial bank, without the approval of the Comptroller of the Currency, the Federal Reserve Board, or the FDIC, on the fundamental basis that the action is in the public interest. All transactions in commercial banks are subject to supervision by one of these three agencies, and under the Cease and Desist Act officers and employees of commercial banks may be suspended or under some circumstances removed. And, perhaps most unusual, deposits in most commercial banks are insured by the FDIC up to amounts which have now reached $100,000.

Under these circumstances, the virtual presumption against mergers which was created by the 1950 amendment to section 7 of the Clayton Act did not make sense for the commercial banking industry, and the Congress very clearly has refused to apply it, even when the Supreme Court came to what I am convinced was an incorrect result in the Philadelphia case.

In addition to these two factors, I think the Congress was influenced in its decision not to apply the 1950 section 7 standards to mergers of commercial banks by its appreciation of the fact that government regulation and control of the commercial banking system had resulted in a banking industry which on the whole was highly competitive, extremely imaginative, and remarkably efficient in performing its function as the nation's payment mechanism and principal source of short and medium term credit.

The commercial banking system, either through the American Bankers Association or some other banking group or in cooperation with the supervisory agencies, has developed bank transit numbers, MICR numbers on checks which make it possible to handle billions of checks a year automatically, automated clearing houses, direct deposit of checks, bank credit and debit cards, and other methods of handling financial transactions speedily and accurately

Along with these examples of effective service as an integrated and efficient banking system, the commercial bank industry is a remarkably competitive set of institutions. This competition is world-wide with foreign banks as competitors as well as the large t American banks. This competition also appears in a regional form, where medium sized banks compete with each other and with the largest American and foreign banks. Local competition can also be intense, with the largest American banks, and sometimes foreign banks, competing with medium sized and small banks. And in the near future mutual savings banks and savings and loan associations will be competing in all these markets on a virtually even footing.

The 14,000 commercial banks in the American banking system provide a competitive and effective banking service, which is, I am convinced, just as effective on the whole and vastly more competitive than most foreign banking systems each with a handful of banks which find it easier to cooperate and harder to disagree and go off on individual and maverick courses of action. I find it hard to believe, for instance that the credit unions in Canada would have found a commercial bank to handle their share drafts, or that a money market fund in Australia or New Zealand would have found a commercial bank to handle their vaunted withdrawals by check. In the United States, credit unions and money market funds found commercial banks to handle their share drafts and check withdrawals, even though the banking in dustry as a whole was fighting the share drafts and check withdrawals in court and in Congress and in the agencies.

One of the elements which has given the United States this effective and competitive commercial banking system is the dual banking system, and the existence of fifty different state systems, combined with fifty different national bank systems, in the fifty states. The dual banking system is expressed in Federal law in the McFadden and Douglas amendments, which generally prohibit branching and holding company acquisitions across state lines. I realize that there are many exceptions to the principles of these amendments, through holding company affiliates carrying on closely related functions in other states, or by loan procurement offices, or by other methods. Clearly the dual banking system is not a matter of logic or consistency. Nevertheless, like the Federal system of government under which we live, I am convinced that repeal of the McFadden and Douglas amendments and complete freedom to branch or acquire bank affiliates nationwide would end state banking systems and would go a long way toward real concentration in American banking.

I do not agree with those who say the antitrust laws would protect against what they and I see as a possibility of concentration that might result from repeal of the McFadden and Douglas amendments. I think the present fragmented, but effective, banking system, supervised by agencies

sensitive both to the need of bank customers--the government, industry and the public--for imaginative and effective banking service and to the need for competition among banks as one of the principal assurances that bank customers will get the best banking service, will provide much greater promise of good banking service and strong competition among banks than would any effort to use the antitrust laws to accomplish these objectives.

The new developments which have recently occurred and which can be expected to occur in the future in the field of depository institutions and in the wider field of financial intermediaries generally will call for many changes in the applicable laws. However, these changes should be based on the principles which the Congress has applied in the past in the field of banking, even though those principles have not always been accepted by the courts or the Antitrust Division:

> The anticompetitive effects of banking policies and activities, particularly mergers and holding company acquisitions, must be weighed against the benefits which might be derived for the community or the customers, in the public interest. The 1966 rejection of the Philadelphia National Bank case holding must be continued and emphasized.
>
> All aspects of competition involved in banking policies and activities, including mergers and bank holding company acquisitions, must be considered, and mergers and bank holding company acquisitions involving other depositories and conversion of thrifts to commercial banks for this purpose or otherwise should be considered.
>
> The nation's fragmented but integrated dual banking system, and the corresponding fragmented but integrated dual thrift system, based on the McFadden and Douglas amendments, should be preserved so far as possible, as the best protection against undue concentration of financial power.

I trust that these comments, based on my experience with the Banking and Currency Committee staff, and on my service with the American Bankers Association (for which I am not speaking in this letter), will be helpful to you and to the Committee.

Sincerely yours,

Matthew Hale

Matthew Hale

Comment on Dr. Austin's Article, "The Evolution of Commercial Bank Merger Antitrust Law"

By MATTHEW HALE*

EDITOR'S INTRODUCTION: In the January, 1981 issue of *The Business Lawyer*, an article on "The Evolution of Commercial Bank Merger Antitrust Law" by Douglas V. Austin appeared.** The following comment on this article was received from Matthew Hale of Westport, New York. Mr. Hale, as a member of the staff of the Senate Banking and Currency Committee, worked on bills which became the Bank Merger Act of 1960, the Bank Merger Act Amendments of 1966, and the Bank Holding Company Act Amendments of 1966. He was counsel, chief counsel, and chief of staff of that Committee during his twelve-year affiliation. Following that experience, he spent eight years as general counsel to the American Bankers Association. Mr. Hale's comments provide helpful historical perspective on the statutes discussed in Dr. Austin's article.

In view of the recent changes in the competitive relations between commercial banks and other financial institutions, and in view of the proposals which have been made to amend or repeal the McFadden Act[1] and the Douglas Amendment[2] to permit branching, mergers and holding company acquisitions across state lines, it seems clear that bank mergers and bank holding company acquisitions, and possibly affiliations between banking institutions and other financial institutions, may become of great importance to the future development of the banking and financial systems. It may be that the Bank Merger Act Amendments of 1966[3] and the Bank Holding Company Act Amendments of 1966[4] should be revised to meet the new conditions, but before amending these statutes, it is appropriate to review their legislative history and their purpose and intent, as well as the interpretations which have been given by the courts to these statutes.

*Member of the District of Columbia, New York, and United States Supreme Court bars.
**36 Bus. Law. 297 (1981).
1. McFadden Act, 44 Stat. 1226 (1927), 12 U.S.C.A. § 24 (1980).
2. Bank Holding Company Act, 80 Stat. 237 (1966), 12 U.S.C.A. § 1842(d)(1) (1980) ["Douglas Amendment"].
3. Bank Merger Act, 74 Stat. 129 (1960), Bank Merger Act Amendments of 1966, 80 Stat. 7, 242, 824 (1966), 12 U.S.C.A. § 1828 (1980).
4. Bank Holding Company Act Amendment of 1966, 80 Stat. 237 (1966), 12 U.S.C.A. § 1842 (1980)

For this reason, articles like "The Evolution of Commercial Bank Merger Antitrust Law" by Douglas V. Austin, and the discussion of case law will be helpful to the bar and perhaps also to the courts. For this reason also, I feel it is desirable to comment on two statements made in Dr. Austin's article, which I consider do not fully reflect the legislative history and background of these statutes.

> 1. The article portrays the Bank Merger Act of 1960 as: "... the attempt by the banking industry and the regulatory agencies to eliminate the possible threat of litigation from the Department of Justice in the commercial bank merger field."[6]
>
> 2. The article states that, "... the purpose [of the 1960 Act] was to thwart the antitrust activities of the Department of Justice ..."[7]

These quotations suggest that the 1960 Act was intended to prevent the Justice Department from carrying out its duties under existing law, by withdrawing from the department powers and duties it then had. This was not the case. On the contrary, the Justice Department and Chairman Celler were just as anxious to obtain legislation in the field of bank mergers as were the bank regulatory agencies and the banking industry. Everyone agreed that the Sherman Act[8] was of no use in controlling bank mergers, and everyone agreed that bank mergers were not covered by the 1950 amendment to section 7 of the Clayton Act,[9] because the only mergers covered by that section as amended were those of corporations "subject to the jurisdiction of the Federal Trade Commission", and banks were subject to the jurisdiction of the Federal Reserve Board. The question was not whether legislation was necessary, but what form the legislation should take.[10]

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5. Austin, *The Evolution of Commercial Bank Merger Antitrust Law*, 36 Bus. Law. 297 (1981).

6. *Id.* at 299.

7. *Id.* at 308.

8. Sherman Anti-Trust Act, 64 Stat. 1125 (1950), 15 U.S.C. §§ 1-7 (1973).

9. Clayton Act, 38 Stat. 730 (1914), 15 U.S.C. § 18 (1970).

10. The legislative history of the 1950 amendment to § 7 of the Clayton Act makes it clear that Mr. Celler knew that the bill which became the 1950 amendment did not cover bank mergers. "Amend the Bank Merger Act of 1960," Hearings on S. 1698, 89th Cong. 2nd Sess. 324, 326-28 (1966). *See also* Hale, *Mergers of Financial Institutions*, 21 Bus. Law. 211 (1965). During the House Debate on H.R. 12173 (a new bill reported by Mr. Patman because S. 1698 had already been reported by Mr. Ashley), Mr. Celler made the following remarks.

> In 1950 ... I for one—and I was in a fairly good position to know—did not understand nor did Senator Kefauver of honored memory understand that the Celler-Kefauver amendment to section 7 was to apply to bank mergers.
>
> Indeed, if I were a lawyer and some bank had come to me and said, "If I were to merge with this particular bank by asset acquisition, would I be violating the law?"—meaning the Celler-Kefauver Act—in good conscience I would have had to say "No" prior to the Philadelphia case.

It seems impossible to escape the conclusion that "the plain congressional purpose in amending section 7" in 1950 was to impose the restrictions of the amendment on corporations, subject to the

The banking agencies recommended that banks should be required to obtain approval for mergers from them, on the basis of competitive factors and factors relating to the public interest and convenience and needs. Two bills along these lines were passed by the Senate during the 1950s, but the House did not act on them.[11] The Justice Department and Chairman Celler supported bills which would have applied the 1950 amendment to section 7 to bank mergers. Two bills of this sort passed the House in the 1950s, but the Senate did not act on them.[12]

The 1960 Bank Merger Act was designed to close this gap, along the lines favored by the banking agencies, and at the time of its final passage by the Senate, the Majority Leader, Senator Johnson of Texas, summarized its purpose and intent as follows:

> This bill establishes uniform and clear standards, including both banking and competitive factors, for the consideration of proposed bank mergers. It eliminates a number of gaps in the statutory framework, which now permit many bank mergers to occur with no review by any Federal agency. It provides for a thorough review by the appropriate Federal bank supervisory agency, under these comprehensive standards, and with the benefit of any information which may be supplied by the Department of Justice in the report required from them, of the bank mergers by asset acquisitions and other means which are now and will continue to be exempt from the antimerger provisions of section 7 of the Clayton Antitrust Act.[13]

In the Senate Banking and Currency Committee report on the bill which became the *1960* Act, the Committee took note of the following statement from the *Bethlehem-Youngstown* opinion.

> . . . If the merger offends the statute in any relevant market then good motives and even demonstrable benefits are irrelevant and afford no defense.[14]

The Report referred to this opinion, and rejected the position:

> The Committee did not consider that it would be in the public interest to regulate bank mergers under standards which would mean that the demonstrable benefits of a merger are irrelevant and outside the province

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jurisdiction of the FTC and only on such corporations, and not to impose these restrictions on banks, which were subject to the jurisdiction of the Federal Reserve Board.

11. S. 3911, 84th Cong. 2d Sess. (1956); S. 1451, 85th Cong. 1st Sess. Tit. 3, § 23 (1957).

12. H R.5948, 84th Cong. 2d Sess. (1956); H.R. 9424, 84th Cong. 2d Sess. (1956).

13. 106 Cong. Rec. 9714-15 (1960) (remarks of Sen. Johnson).

14. United States v. Bethlehem Steel Corp., 168 F. Supp. 576, 617 (S.D. N.Y. 1950), *quoted in* S. Rep. No. 196, 86th Cong., 1st Sess., at 6 (1960).

of the administrator, and which would make no distinction between good mergers and bad mergers.[15]

The *Philadelphia National Bank* decision[16] was a complete surprise to the Congress, to the banking industry, and no doubt to the five representatives of the Department of Justice who had requested legislation from Congress on the ground that the 1950 amendment to the Clayton Act did not cover bank mergers. In words reminiscent of Judge Weinfeld's opinion in the *Bethlehem-Youngstown* case, Justice Brennan set forth the following rule:

> We are clear, however, that a merger the effect of which "may be substantially to lessen competition" is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial. A value choice of such magnitude is beyond the ordinary limits of judicial competence, and in any event has been made for us already, by Congress when it enacted the amended § 7. Congress determined to preserve our traditionally competitive economy. It therefore proscribed anticompetitive mergers, the benign and the malignant alike, fully aware, we must assume, that some price must have to be paid.[17]

The Congressional response to the Philadelphia decision was the Bank Merger Act Amendments of 1966.[18] Dr. Austin sets forth the legislative history of the Act, though not with the liveliness of the *Wall Street Journal* article by Arlen J. Large—"The Bank Merger Bill's Zany Journey"—which Senator Hart inserted in the Congressional Record during the debate on the bill on February 9, 1966.[19] Dr. Austin correctly shows that Representative Ashley played a significant role in bringing about action on the Senate proposal, though he omits the fact that Representative Ashley, with the approval of a majority of the House Committee, reported S.1698 from the Committee, with a report which called on the agencies and the courts to take into consideration local, regional, national and international competition between banks and between banks and other financial institutions, and to recognize both the benefits to banks and their customers of vigorous competition, and "the importance of sound and strong banks which can provide the banking services essential to the full development of the economy, to full employment and full production."[20] When the bill finally was passed by the

15. S. Rep. No. 196, *id* at 19.
16. United States v Philadelphia Nat'l Bank, 374 U.S.321 (1963).
17. *Id.* at 371.
18. Bank Merger Act Amendments of 1966, *supra* n. 3.
19. 112 Cong. Rec. 2650, 2660 (1966) (remarks of Sen. Hart).
20. H. Rep. No. 1179, 89th Cong. 1st Sess. (1966). The text of the bill reported by Representative Ashley contained the following standards:

> (5) The responsible agency shall not approve any merger unless it finds that such transaction will not violate the antitrust laws, except that in considering the application of the antitrust

Senate, Senator Robertson paid a special tribute to Congressman Ashley for his untiring and constructive efforts on the bill. Dr. Austin correctly states that Representative Patman opposed the bill in every way he could, and even after the compromise which led to his reporting a bill, he would have preferred no bill at all. It might be noted that it was Representative Patman's extreme opposition to the bill, and his efforts to prevent its passage, that led to a substantial reduction in the powers of chairmen in the House, and eventually to the change in rules which authorized the majority members of a committee in the House to choose its chairman, in disregard of the seniority rule.

The basic change made by the bill from the Philadelphia rule was the provision in section 1828(c)(5) that a merger which might substantially lessen competition should nevertheless be approved if "[its] anticompetitive effects are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served."[21] Paragraph (c)(7)(B) provided that in any antitrust action against a merger approved under the act, except one under section 2 of the Sherman Act, "the standards applied by the court shall be identical with those that the banking agencies are directed to apply."[22] In other words, the courts as well as the agencies should not follow the section 7 rule laid down by Judge Weinfeld and Justice Brennan, but must make an "ultimate reckoning of social or economic debits and credits" and must determine on the basis of this reckoning whether the proposed merger is "benign" or "malignant."[23]

A second major change made by the bill, according to Senator Robertson, was that it called for consideration of all competitive factors in a proposed merger, not just the effects within the field of commercial banking. In reply to a question from Senator Long of Missouri as to whether competition meant just competition from commercial banks, Senator Robertson said:

> No; that would be entirely unrealistic. At the present time the banking agencies consider as relevant the competition afforded to commercial banks by other financial institutions, for example, savings and loan associations, credit unions, insurance companies, mutual savings banks,

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> laws to merger transactions, the responsible agency, the Attorney General, and any court reviewing the legality of such transaction shall take into account the effect on the public interest and the community to be served of the following banking factors: ... (E) the convenience and needs of the community to be served, ...
>
> A merger transaction which tends to lessen competition may be approved where the probable adverse competitive effect thereof is clearly outweighed in the public interest by the probable effect of such transaction in meeting the convenience and needs of the community to be served.

This provision clearly incorporates by reference the line of commerce phrase in § 7, but even so Representative Ashley and the Committee members who joined him in this report intended the agencies and the court to consider competition from thrifts and others, not to limit themselves to the commercial banking line of commerce.

21 12 U.S.C. § 1828(c)(5).

22. 12 U.S.C. § 1828(c)(7)(B).

23. Philadelphia Nat'l Bank, *supra* n. 16.

> and small loan companies. Such financial institutions compete with commercial banks and the effect of this competition must be considered by the agencies and by the courts when a proposed merger of commercial banks is being questioned.[24]

In a statement inserted by Senator Robertson during the debate on the bill, he discussed monopoly and competition in banking, including local, regional and national competition among banks and competition between commercial banks and thrifts and other financial institutions. He pointed out the omission from the bill of the Clayton Act phrase "in any line of commerce," and stated that the omission meant that the agencies and the courts should consider "the overall effects of the merger on competition" and "the increase of competition in the entire field of banking and in the broader field of financial institutions which may result from other aspects of the merger."[25] The opinion in the *Crocker-Citizens*[26] case relied on Senator Robertson's views when the court took into consideration competition from nonbank institutions in sustaining that merger. The Supreme Court noted the omission of the "line of commerce" phrase in a footnote in the *Houston*[27] case, but took no position, in that or any other opinion, except the *Connecticut* case in which the Court said it made no difference, on the effect of the omission.

It is ironic that controversy about "commercial banking" as a line of commerce revolves around a phrase that does not appear in the statute being applied.

Even before the House passed the bill, Senator Robertson sent to the members of the Senate Banking Committee copies of the House Report and a letter dated January 25, 1966 concerning the bill. Senators Douglas and Proxmire replied,[28] questioning the new standards and the authorization for

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24. 112 Cong. Rec 2650, 2664 (1966) (remarks of Sen Robertson). This practice followed the policy laid down in 1960 in a memorandum of questions and answers prepared by Senator Robertson and Senator Bennett (the ranking Republican on the Senate Banking and Currency Committee) which was inserted in the Congressional Record just before the Senate vote on the 1960 Act.

> Question In considering a proposed merger, would the responsible Federal Banking Agency be able to take into consideration the competition which the merging banks face, and the merged bank would face, from other kinds of financial institutions—savings and loan associations, credit unions, insurance companies, finance companies, and the like?
>
> Answer: Yes, indeed. All competition which the merging banks now face, and which the merged bank would face, must be taken into consideration by the banking agency. This includes both competition from other banks and trust companies, and competition from other financial institutions which may provide the same or similar services It includes competition for the public's funds, in the form of deposits, savings accounts, and the like, and it includes competition in supplying the public's needs for funds in the way of personal loans, consumer credit, mortgages, business loans, and so on.

106 Cong. Rec 9710, 9713 (1960)

25. 112 Cong. Rec 2650, 2655 (1966) (remarks of Sen Robertson).

26 United States v. Crocker-Anglo Nat'l Bank, 277 F Supp. 133 (N.D. Cal. 1967).

27 United States v First City Nat'l Bank of Houston, 386 U.S. 361, 369 n. 1 (1967).

28. 112 Cong. Rec. 9632, 9635 (May 3, 1966).

agency lawyers to appear in antitrust cases. Senator Robertson answered this,[29] and called an informal session of the Committee on February 8th, the day the House passed the bill, at which the House bill and Report were discussed. Also on February 8th Senator Robertson inserted the House Report in the Congressional Record, and sent a letter to all senators, saying he would bring up the bill the next day.[30]

The bill was debated extensively on February 9th. Senator Hart objected to the change in the standards for approval, and urged that the bill should be sent to the Judiciary Committee for further consideration. Senator Robertson opposed this, and the motion was tabled and the bill passed by the Senate and became law.

In June of 1966, the Senate considered a bill, H.R. 7371,[31] to eliminate two exemptions from the Bank Holding Company Act. The Senate Banking Committee added an amendment which provided the same standards and procedures for bank holding company acquisitions as the recently adopted Bank Merger Act Amendments had provided for bank mergers. The Justice Department strongly opposed this amendment, pointing out that bank holding company acquisitions were clearly covered by the Clayton Act, in contrast to the "uncertainty" about bank mergers. Senator Robertson, in describing the amendment, referred to the discussions of the 1966 Bank Merger Act Amendments at the time of passage as indicating the intent and effect of the changes. Senator Hart moved to strike this amendment from the House bill. His motion was defeated by a vote of 16 yeas to 64 nays. The House accepted the Senate amendment, and the bill became the Bank Holding Company Act Amendments of 1966. The application of the Clayton Act to bank holding company acquisitions of banks was repealed, and the standards of the Bank Merger Act Amendments of 1966 were adopted.

The resounding vote by which Senator Hart's attempt to retain the restrictions of section 7 of the Clayton Act on bank holding company acquisitions was defeated make it clear that the Senate did not want the strict rule of section 7, as set forth by Judge Weinfeld in the *Bethlehem-Youngstown* case[32] and by Justice Brennan in the *Philadelphia* case,[33] to apply to any bank acquisitions by any method. On the contrary the Senate clearly wanted the banking agencies and the courts to consider the benefits of the acquisition to the community to be served and the public interest in good banking services. The House accepted this amendment.

The area of competition to be considered—the "line of commerce" issue—reflects the changing circumstances from 1960 to 1966 to the present. In 1960 there was considerable competition between thrift institutions and commer-

29. *Id.* at 9635-36.
30 *Id* at 9636
31. H.R. 7371, 89th Cong. 2d Sess., 111 Cong. Rec. 24916 (1965).
32. Bethlehem-Youngstown, *supra* n. 14.
33. Philadelphia Nat'l Bank, *supra* n. 16.

cial banks for savings deposits and between commercial banks and other institutions for loans. However, commercial banks were the only institutions that offered checking accounts (except for a few savings banks in New Jersey and Maryland), and therefore were the only institutions that "created" money by making loans through demand deposit accounts and that formed a part of the payments mechanism. By 1966, as Representative Ashley's Report No. 1179[34] and Senator Robertson's comments in the Senate show, commercial banks and thrift institutions were competing even more vigorously for savings accounts and for consumer loans and home mortgages, and other competitors such as finance companies were becoming increasingly vigorous. But it was still true in 1966 that commercial banks were the only institutions that offered demand accounts, and thus "created" money, and the only institutions that participated in the payments mechanism.

This is no longer the case. All depository institutions are authorized to offer NOW accounts (share drafts in the case of credit unions), which for individuals perform exactly the same service as checks, and the thrifts now participate in the payments mechanism, and belong to automated clearing houses and accept direct deposits of pensions and Social Security payments. The thrifts can now offer overdraft NOW accounts and bank cards, which "create" money. As far as individual customers are concerned, the thrifts now offer virtually every service that commercial banks can offer, sometimes on more favorable terms. The thrifts are also beginning to offer competition in the field of business loans and other transactions, though this has not progressed to a substantial extent in most areas.

In addition, the money market funds are providing sharp competition to both commercial banks and thrifts, for money which would otherwise go into savings or demand accounts. These funds were reported on March 12, 1981 to have reached the total of $100 billion. In rural areas, the agencies of the Farm Credit Administration and the Farmers Home Administration also provide funds to farmers and other businesses. Automobile and appliance credit companies provide funds for equipment which otherwise might be advanced by commercial banks in the form of floor loans to dealers or direct loans to buyers.

In short, the basis on which the *Philadelphia* opinion established commercial banking as the appropriate line of commerce has completely disappeared as far as individuals are concerned, and has lost much of its force as far as business deposits and loans are concerned.

Accordingly, instead of considering the effect of a merger or holding company acquisition on percentages of bank deposits in a so-called banking market, it seems more appropriate to consider whether the resulting institutions would have "market power", in the sense used by Areeda and Turner,[35]

34. H Rep No. 1179, *supra* n. 20.

35. Areeda and Turner, Antitrust Law (1980) *See* Landes and Posner, *Market Power and Antitrust Cases* 94 Harv. L. Rev. 937 (1981). Market power over money and over banking

over any of its or their customers or any class of customers—in other words whether the resulting institution would be able to impose excessive and noncompetitive fees or charges for loans or other services or to pay unreasonably low and noncompetitive charges for savings deposits or other acquisitions by the institution. Basically this comes down to a question of alternatives. For an individual, the bank customer who is most concerned with the convenience of a local office, the alternatives to a commercial bank are now virtually equal in any but the most remote areas: a NOW account at a commercial bank gives just as good service as a NOW account at a thrift; a savings account at either institution is just the same, except that the thrift may pay a higher rate of interest; bank cards are the same at either institution; home mortgages are probably easier to obtain at a thrift; personal loans may be easier to obtain at a commercial bank, or at a credit union. So it seems clear that the line of commerce for individual financial services should include savings and loans, savings banks and credit unions, insofar as they are conveniently available to the customer.

For major national or international corporations, the local banking market is unimportant. These corporations, seeking loans or maintaining accounts in the hundreds of thousands or millions of dollars, do their banking business in regional or national or international markets. In the United States, with our fragmented dual banking system, it is impossible to imagine a merger of local or regional banks which would give the resulting institution market power over any member of the Fortune 500.

Small and medium sized business firms, which do not have access to the regional markets, and which cannot yet benefit from expanded thrift powers, are probably the only bank customers which could be hurt by a local merger which might reduce or eliminate commercial bank alternatives for them. Even for them, it would be necessary to consider such alternatives in a rural area as the Farm Credit Administration with its Federal Land Banks, Federal Intermediate Credit Bank and Production Credit Associations, or the Farmers Home Administration.

If the line of commerce is to be considered, and percentage shares of deposits are to be weighed in deciding whether a proposed merger would result in an unreasonable share of the deposits, it would seem necessary at least to eliminate the deposits of the big corporate depositors and the deposits of individuals from the calculations. The same eliminations would seem appropriate for loans to big corporations and to individuals. Calculations based on the deposits of, or loans to, big corporate customers and to individuals who might not be affected by the merger would be misleading, or at the least meaningless, from the point of view of the effect of the merger on competition. Certainly for individuals, any calculation of market shares which does not

services must be taken with a grain of salt. Money is not a commodity, it is a means of payment and a store of value.

take into account alternative sources of supply of banking services from thrifts in the community is unrealistic.

In the course of the debate on the Bank Merger Act Amendments of 1966 in the Senate on February 9th, Senator Robertson summed up what he thought the bill required the banking agencies and the courts to consider in reviewing a proposed merger:

> The effect of the merger on the public interest and on the convenience and needs of the community to be served must be measured in specific and realistic terms in the light of the kinds of business involved and the kinds of people being served. The banking agencies and the courts must be guided by the realities of the industrial, commercial, and financial worlds. They must look through theories and percentages and doctrines to the hard facts of life.[36]

I trust that the time has come for a new look at the Bank Merger Act and the Bank Holding Company Act in light of today's and tomorrow's situations, in the terms recommended by Senator Robertson. It may be necessary to enact new legislation to cover mergers and other acquisitions of mutual savings banks and savings and loan associations with each other and with commercial banks. Any such legislation should include the principles which I am convinced the Congress wrote into the Bank Merger Act Amendments and the Bank Holding Company Act Amendments in 1966—realistic consideration of the effects of the proposed merger, good and bad, on the various customers of the institutions involved, and the effects of the proposed merger, good and bad, on the local, regional, and national markets which the institutions serve, not limited by artificial and unrealistic lines of commerce and geographic market areas.

36. 112 Cong. Rec. 2650, 2656 (1966).

MERGERS OF FINANCIAL INSTITUTIONS

By

MATTHEW HALE*

Washington, D. C.

I appreciate the opportunity to speak before the Savings and Loan Associations Committee of the Corporation, Banking and Business Law Section. I have enjoyed the benefits of membership in the section for many years, and I trust I can contribute something in return.

I must preface my remarks by making it clear that I am not speaking for the Banking and Currency Committee or any member of it, though I must at the same time acknowledge that I am taking full advantage of what I have learned while working for the committe.

Mergers of financial institutions is a challenging topic to discuss at a meeting of the American Bar Association. The impact of the antitrust laws on a regulated industry, and the effort to reconcile the procedures and objectives of the regulatory statutes and agencies with the often conflicting procedures and objectives of the antitrust laws, have created a new and rapidly developing field of law, which has had tremendous effect already in the field of bank mergers.

The issues and the problems growing out of the application of the antitrust laws to regulated industries affect many areas. Railroads, airlines, and pipelines and their regulatory agencies have for years tried to reconcile the two bodies of law. In 1963 the Supreme Court, in the *Silver* case, held that the Sherman Act applied to certain of the self-regulatory functions vested in the New York Stock Exchange under the Securities Exchange Act of 1934, and 10 days ago the SEC reported to the chairman of the Banking and Currency Committee that it was taking up with the industry the possibility of legislation to clarify the relation between the securities laws and the antitrust laws.

I should like to start by speaking about banks and bank mergers, because the most legislation and the most litigation have occurred in this part of the world of financial institutions. Then I would like to speak more particularly about savings and loan associations.

The impact of the antitrust laws on banking and bank mergers has been startling and confusing. In my judgment, the reason is simple. Ever since 1791 when the first Bank of the United States was created, banking has been regulated and controlled, in one way or another, under the money power and under standards related primar-

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*Member of the D. C. Bar; Chief of Staff, Senate Committee on Banking and Currency. From a paper delivered at the Annual Meeting in Miami before the Section's Committee on Savings and Loan Associations on August 11, 1965.

ily to the money power, with consideration being given to competition because competition helps to carry out the objectives sought through the exercise of the money power. Now suddenly the Supreme Court has held the antitrust laws applicable to banking, in their most stringent form, in disregard of the intention of Congress and of the effect on the statutory regulatory scheme developed by Congress over the century and three-quarters of trial and error since 1791.

The conflict between competition and monopoly—more accurately between varying degrees of competition and monopoly—has been carried on throughout the Nation's history. Hamilton and Jefferson, Jackson and Biddle, Carter Glass and Huey Long, fought over different aspects of this issue. The second Bank of the United States—which many feared would monopolize all the banking of the United States—was succeeded by the era of free banking, under which, in many States, anyone could open his own bank and issue his own bank notes, just the way one could open and run one's own savings and loan association in Maryland in recent years, with no supervision and no security.

As might be expected, the era of free banking ended in disaster. The story is clearly told by Senator John Sherman, who in 1863 introduced the bill which created the National Bank System, who was Secretary of the Treasury under President Hayes, and who in 1890 sponsored the Sherman Antitrust Act. Senator Sherman, in his "Recollections of 40 Years in the House, Senate, and Cabinet," described the story this way:

"The issue of circulating notes by State banks had been the fruitful cause of loss, contention, and bankruptcy, not only of the banks issuing them, but of all businessmen depending upon them for financial aid. Inflation and apparent prosperity were often followed by the closing of one bank and distrust of others . . . . With a narrow view of the powers of the National Government, Congress had repeatedly refused to authorize a national bank, a policy I heartily approve, not from a doubt of the power of Congress to grant such a charter, but from the danger of intrusting so vast a power in a single corporation, with or without security. This objection did not lie against the organization of a system of national banks extending over the country."

The establishment of Senator Sherman's countrywide system of national banks, together with the revival of the State bank system, has created today's highly competitive dual banking system.

Further efforts to promote sound banking, and at the same time to preserve competition and prevent monopoly in the field of banking, resulted in the Glass-Steagall Act of 1932, which separated investment banking and commercial banking, the McFadden Act of 1927, as amended in 1933, which reduced the spread of branch

banking and made national bank branching conform to State banking laws, the Bank Holding Company Act of 1956, and the Bank Merger Act of 1960.

The legislative history of the Bank Merger Act of 1960 makes it clear that it was designed to promote competition and prevent monopoly. The act specificaly requires the agency reviewing the proposed merger, in addition to considering banking factors, including the convenience and needs of the community to be served, to consider the effect of the transaction on competition, including any tendency toward monopoly. The agency is required to deny the merger, unless after considering all of these factors, it finds the merger in the public interest.

At the same time, it is clear that Congress has recognized the special factors applicable to banking. The Congress in 1960 specifically rejected the strict Clayton Act rule under which "good motives and even demonstrable benefits are irrelevant and afford no defense," as the Court said in the *Bethlehem Steel* case. The Congress in 1960 specifically ruled out the proposal that competitive factors should be controlling; instead, a balanced approach was provided, in which the public interest in the soundness and good management of the banking system—the public convenience and necessity—would be considered along with competitive factors.

The antitrust laws have an entirely different focus. They emphasize competition, full and free competition, at times to the exclusion of all other factors. The basic problem involved in the application of the antitrust laws to banking has never, I think, been more clearly and more cogently expressed than by Mr. A. A. Berle in 1949, when he warned banks of the possibility that the antitrust laws might be applied to them:

> Operations in deposit banking not only affect the commercial field, but also determine in great measure the supply of credit, the volume of money, the value of the dollar, and even, perhaps, the stability of the currency system. Within this area considerations differing from and far more powerful than mere preservation of competition may be operating under direct sanction of law. It is the theory, in ordinary commercial fields, that competition is the desirable check on price levels—the process by which the efficient are rewarded by survival, and the inefficient eliminated by failure. The price of business failures is not regarded as too high for the community to pay in view of advantages to consumers, stimulus toward greater efficiency, and freedom of enterprise. But it is doubtful (to say the least) whether any such assumption is indulged in with respect to deposit banks; certainly the theory is not there accepted to the full extent of its logic. A bank failure is a community disaster, however, wherever, and whenever it occurs. While competition may be desirable up to a point in deposit banking, there is a clear bottom limit to its desirability. So long as 90 percent of the monetary needs of the country are supplied through bank credit, deposits, and checks, under a system which contemplates many thousand of banks and also a uniform, smooth, free flow of bank checks, a high degree of cooperation among banks is essential.

> So long as certain kinds of banking paper are accepted as a basis for currency through the operations of the Federal Reserve rediscount, a high factor of uniformity is needed. The economic and social premises of the Sherman Act in respect of other businesses are not fully accepted by the Congress, the States, or the public as the only considerations applicable to deposit banking.

Certainly even the most enthusiastic advocate of bank competition would not advocate free entry into banking—letting anyone start a bank without first getting approval, without consideration of public convenience and necessity and without consideration of his qualifications—unrestricted branching, unlimited lending and investment powers, or unrestricted merging, subject only to the antitrust laws.

The fact is that Congress never intended the Sherman Act or the 1950 Celler-Kefauver Antimerger Act to apply to banking or to bank mergers. This does not mean, of course, that Congress has not favored competition in banking. But it does mean that Congress did not intend or want ~~expect~~ to bring about competition or to prevent monopoly in banking, by means either of the Sherman Act or the Celler-Kefauver Antimerger Act.

The position taken by Mr. Justice Frankfurter in his dissenting opinion in the *Southeastern Underwriters* case in 1944—that the Sherman Act was not intended to and did not apply to insurance—is even more clearly applicable to banking, where Senator Sherman's countrywide system of independent national banks had been functioning for 25 years by the time he introduced and Congress passed the Sherman Antitrust Act. Justice Frankfurter said:

> The relations of the insurance business to national commerce and finance, I have no doubt, afford constitutional authority for appropriate regulation by Congress of the business of insurance, certainly not to a less extent than congressional regulation touching agriculture. But the opinion of the Chief Justice leaves me equally without doubt that by the enactment of the Sherman Act in 1890, Congress did not mean to disregard the then accepted conception of the constitutional basis for the regulation of the insurance business. And the evidence is overwhelming that the inapplicability of the Sherman Act, in its contemporaneous setting, to insurance transactions such as those charged by this indictment has been confirmed and not modified by congressional attitude and action in the intervening 50 years. There is no congressional warrant therefore for bringing about the far-reaching dislocations which the opinions of the Chief Justice and Mr. Justice Jackson adumbrate.

The *Southeastern Underwriters* decision was promptly reversed by the Congress, which passed the McCarran Act to return the regulation of insurance to the States.

In the Lexington, Kentucky case the Court did not even discuss the question of the applicability of the Sherman Act to banking. While the Court conceded there was no predatory purpose in the merger it did not even discuss the factors which led the Comptroller of the Cur-

rency to approve the merger on the ground that it would be in the public interest—the desirability and necessity for a bank large enough and with sufficient strength of organization to attract and hold the deposits of the larger industrial and commercial concerns coming to Lexington and the State of Kentucky as part of the modern high grade industrial development of that part of Kentucky. The Court took the position that the broad considerations for determining what constitutes unreasonable restraint spelled out in the Columbia Steel case should be confined to the special facts of that case, and held that the merger was barred merely by a finding that significant competition between the two merging banks was eliminated, on the basis of the four railroad cases which most antitrust lawyers had thought were obsolete.

The Philadelphia decision, holding that section 7 of the Clayton Act, as amended by the 1950 Celler-Kefauver antimerger amendment, applied to bank mergers, almost completely nullified the Bank Merger Act, as Mr. Justice Harlan pointed out, in his dissenting opinion in the Philadelphia case, with which Justices Stewart and Goldberg agreed.

In the course of the consideration of Senator ROBERTSON's S. 1698, the amendment to the Bank Merger Act which is now pending before the House Banking and Currency Committee, I had occasion to review the legislative history and background of the 1950 amendment to section 7 of the Clayton Act and its relation to the Bank Merger Act of 1960, and a memorandum on this subject is included in the hearings on the bill.

My study of the question left me in complete disagreement with Mr. Justice Brennan's conclusion in the *Philadelphia* case that section 7 of the Clayton Act applies to bank mergers. He said in the course of his opinion that "any other construction would be illogical and disrespectful of the plain congressional purpose in amending section 7, because it would create a large loophole in a statute designed to close a loophole."

Legislation is a practical, political process. What a bill does not cover is often just as important for its chances of enactment as what it does cover.

Mr. Justice Brennan further said that "there is no indication in the legislative history to the 1950 amendment of section 7 that Congress wished to confer a special dispensation upon the banking industry."

The original section 7 of the Clayton Act applied only to stock acquisitions. The House and Senate reports on the original section 7 indicated that it was intended to apply to holding companies whose primary purpose is to hold stocks of other companies. During the 1930's and 1940's it became apparent that mergers and other asset acquisitions were just as effective means of promoting monopolies and restraining competition as holding companies. Beginning in 1945

many proposals were made to cover this loophole, culminating in the 1950 Celler-Kefauver antimerger amendment.

On five different occasions during the period the antimerger amendment was under consideration, the Federal Reserve Board pointed out to the House and Senate Judiciary Committees that it would not cover bank mergers. The Board recommended on several of these occasions that the bill be amended so as to cover bank mergers, and on March 21, 1945, it submitted a revised draft of the then pending bill which would have required prior approval by the Federal Reserve Board of bank stock or asset acquisitions. When early versions of the antimerger proposal were reported by the House Judiciary Committee in 1946, they covered only asset acquisitions by corporations subject to the jurisdiction of the Federal Trade Commission. The reports pointed this out and specifically stated that the jurisdiction and regulatory powers of the Federal Reserve Board remained unchanged.

On October 12, 1950, only 2 months before the enactment of the Celler-Kefauver antimerger amendment, the Federal Reserve Board wrote to Chairman CELLER and again reminded him that the bill would not apply to bank mergers. They said:

> H. R. 2734 which passed the House of Representatives on August 15, 1949, and is now pending in the Senate, would broaden section 7 of the Clayton Act so that it would also apply to acquisitions of assets—but only in the case of corporations that are subject to the jurisdiction of the Federal Trade Commission * * *. However, even with the enactment of H. R. 2734, section 7 would continue to be confined to acquisitions of capital stock insofar as banks are concerned.

Chairman CELLER, it seems, had no question that this omission was deliberate and intentional. On July 5, 1955, during the course of hearings on Chairman CELLER's bill to amend section 7 of the Clayton Act so as to cover bank mergers, Judge Barnes, then Chief of the Antitrust Division of the Department of Justice, testified in support of the bill. He pointed out that the 1950 Celler-Kefauver antimerger amendment covered only corporations subject to the jurisdiction of the Federal Trade Commission and that since the Clayton Act placed banks under the jurisdiction of the Federal Reserve Board, the amendment did not apply to banks. Judge Barnes referred ~~in~~ to a footnote ~~to~~ in? a 1952 House Judiciary Subcommittee staff report issued by Chairman CELLER which stated that because of revisions in the amendments to section 7, "it became impracticable to include within the scope of the act, corporations other than those subject to regulation by the Federal Trade Commission. Banks, which are placed squarely within the authority of the Federal Reserve Board by section 11 of the Clayton Act, are therefore circumscribed insofar as mergers are concerned only by the old provisions of section 7."

Judge Barnes went on with his statement ~~of~~ to Chairman CELLER:

> I am sure the chairman will be interested in the notation attached as note 1, because on a previous occasion I raised a question whether or not

to believe

> this was an intentional omission or an inadvertent omission. I was inclined to believe it was inadvertent. Your chairman was inclined that it was not; that it had been discussed. A further examination of the history proves that you were right and my supposition was wrong, Mr. Chairman.

During most of the 10 years between the enactment of the 1950 Celler-Kefauver antimerger amendment and the Bank Merger Act of 1960, efforts were made to restrict bank mergers, either by amending section 7 to apply specifically to banks, as Chairman Celler proposed in 1955, or to amend the Federal Deposit Insurance Act or some other banking statute so as to apply special restrictions to bank mergers, as the Federal Reserve Board had proposed in 1945. During this period, the President, the Department of Justice, and all informed members of the House and Senate urged the enactment of legislation, on the understanding that section 7 did not apply to bank mergers.

The Congress, in the course of its consideration of the Bank Merger Act of 1960, made a deliberate decision not to apply the strict provisions of section 7 of the Clayton Act to bank mergers, but instead to apply more general standards, taking into consideration both the public convenience and necessity and the competitive factors.

This decision was clearly expressed just before the bill passed the Senate in 1960, after the Senate accepted the House amendments, in the following remarks:

> This bill establishes uniform and clear standards, including both banking and competitive factors, for the consideration of proposed bank mergers. It eliminates a number of gaps in the statutory framework, which now permit many bank mergers to occur with no review by any Federal agency. It provides for a thorough review by the appropriate Federal bank supervisory agency, under these comprehensive standards, and with the benefit of any information which may be supplied by the Department of Justice in the report required from them, of the bank mergers by asset acquisitions and other means which are now and will continue to be exempt from the antimerger provisions of section 7 of the Clayton Antitrust Act.

There are many reasons why it is appropriate for mergers of financial institutions to be handled by special legislation under special standards designed for them, rather than by the usual antitrust standards applicable to ordinary commercial and industrial enterprises.

The importance of banks, and this is true of savings and loan associations also, to the Nation's money supply and economic welfare generally has made it necessary for the Government to regulate banks and savings and loan associations and has made it necessary for the Government to underwrite the solvency of the bank system and the savings and loan system through the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation. As Mr. Berle said, "a bank failure is a community disaster, however, wherever, and whenever it occurs."

The same is true of failures of savings and loan associations. The few recent bank and savings and loan association failures, the effects of which were minimized by FDIC and FSLIC insurance, remind us of the tragic results to depositors, and also to the Nation's business and commerce, of the wholesale bank and savings and loan failures of the early 1930's. The need for Government regulation of financial institutions demonstrates the importance of these institutions to the Nation. Government regulation to achieve these national purposes is vital to the Nation and may in many respects outweigh the importance of antitrust objectives, if at any given point the regulatory objectives and the antitrust objectives conflict.

Bank regulation has always called for a high degree of competition in the field of banking and other financial institutions, long before antitrust objectives were spelled out in the antitrust laws. Senator Sherman's countrywide system of independent national banks, and the thousands of State banks, which together make up the dual banking system—some 5,000 National banks and some 9,000 State banks—present a very different situation from the big concentrated nationwide industries which the antitrust laws were primarily designed to handle. In the industrial and commercial world there is a real and present danger of nationwide monopoly. The big oil, tobacco, steel, and aluminum firms could take over the entire production and distribution systems in their fields. They could control or own 100 percent of the industry, and when one concern gets 30, 40, or 50 percent control of the industry's facilities, the danger of monopoly is evident. But under the dual banking system, with its thousands of banks divided into 50 different State systems, even the biggest bank held less than 5 percent of the Nation's deposits on June 30, 1965. While there is much banking by mail, and while the biggest banks make loans outside their States and receive deposits from outside their States, their branches must be confined to their home States, and in most cases to their home cities or counties or some other more limited area.

Thirty-five different banks in 14 different cities have deposits of more than $1 billion each. There is a great deal of competition among them and among many of the other big banks for business from the big nation-wide industrial concerns. In view of the ease of banking by mail or by telephone, this competition is real and significant.

The danger of local monopoly is in fact greater, though even in the smallest locality the ease of banking by mail or by automobile or telephone is such that competition from other towns and cities can be substantial.

In addition, there is a great deal of competition between one kind of financial institution and another. Banks and savings and loan associations compete for the Nation's savings, and insurance companies, mutual funds, and credit unions join in the competition. Banks and savings and loan associations compete for the opportunity to

make mortgage loans on residential and on commercial property, and insurance companies and mortgage bankers join in this competition, too.

It is clear from the legislative history of the Bank Merger Act that Congress wanted to give consideration to local competition, regional competition, and national or international competition, and to competition from savings and loan associations, credit unions, insurance companies, finance companies and the like. In other words, Congress was concerned about the realities of competition, to the lenders and borrowers involved, and to the sum total of these factors, not just to any single factor. In addition, Congress made it clear that consideration should be given to the need for accommodation of the growing capital requirements of an expanding economy, in the community, in the area, and in the country generally. These considerations—the public convenience and necessity and the over-all effects on competition in the broadest sense—were the factors which Congress wished to consider. Congress specifically rejected the Clayton Act test for bank mergers—whether a merger might tend to substantially lessen competition in any one line of commerce in any one section of the country.

Congress wanted to control bank mergers. It wanted to prevent those which were not in the public interest and to permit those which were in the public interest. Accordingly, the benefits of the Bank Merger Act depend on the individual mergers approved, denied, and abandoned without formal application. While aggregate numbers are therefore not conclusive, it is appropriate to note that 180 mergers took place in each of the 5 calendar years before enactment of the Bank Merger Act, and the average for the 5 years beginning with the enactment of that act fell to 153. It also seems appropriate to contrast the number of bank mergers with the FTC report that 1,797 mergers occurred in 1964, most of which were without benefit of any premerger notification to the Government or any premerger governmental review or approval.

We are faced with a strange situation. A banking agency—the Comptroller of the Currency, for example—exercising a power vested in him by the Congress under the Bank Merger Act, after obtaining comments from the other banking agencies and the Department of Justice, may approve a proposed merger on the ground that it is in public interest—that it will benefit the public. The Department of Justice can then sue under the antitrust acts, either before the merger is consummated or apparently at any time in the next 10 or 20 years, and attempt to divide the merged bank into two separate banks, presumably restoring the status quo, however impossible this may be as a matter of practical fact.

Congress did not intend this. Congress did not expect this. It is the result of what I think is an incorrect and unsupportable interpreta-

tion of the 1950 Celler-Kefauver antimerger amendment and the Sherman Act. One may hope that after careful and informed reconsideration, the Supreme Court may reverse itself, as it has so many times in the past.

Such a conclusion would, incidentally, follow that reached by Carl Kaysen and Donald F. Turner, now Assistant Attorney General in charge of the Antitrust Division, in their 1959 book, entitled "Antitrust Policy: An Economic and Legal Analysis." In this book, Messrs. Kaysen and Turner list commercial banking as part of the exempt sector:

> By exempt sector we mean that part of the economy to which antitrust policy does not apply because of legislative exemptions, expressed or implicit. To be sure, this exemption is not complete and in some cases the legislation exempting an industry contains its own antimonopoly provisions. * * * The objectives of antitrust policy are either subordinated to other policy goals or sought through direct regulation.

And in a table showing the character of the regulation of these exempt industries, Messrs. Kaysen and Turner give the following information about commercial banking:

"Federal Reserve controls general level of interest rates and availability of credit. Federal and State authorities control bank operations through entry controls and examinations. Limitation of competition is considered by regulation authorities as necessary to stability of banking systems."

Senator ROBERTSON's bill, S. 1698, as he introduced it, was designed to restore the situation as it was understood to be when the Bank Merger Act of 1960 was passed—in other words it would have restored the Bank Merger Act as the controlling statute with respect to bank mergers. It would have exempted all bank mergers from the Clayton Act, which was not intended to apply to bank mergers, and from the Sherman Act, which was understood up to the *Lexington, Kentucky,* case to have no significance with respect to bank mergers. This bill was strongly supported at the hearings held before the Banking and Currency Committee in May. However, when it became evident that there might be protracted discussion of this bill, Senator ROBERTSON, in order to get quick action on the parts of the bill for which there seemed to be unanimous support in the committee and among the witnesses, accepted and supported an amendment proposed by Senator PROXMIRE based upon a suggestion by the Federal Reserve Board. As amended, the bill would no longer constitute a general exception for bank mergers from the antitrust laws. Instead, it would be a bill to eliminate the necessity of unscrambling bank mergers. It would postpone for 30 days the consummation of bank mergers approved in the future, to give the Justice Department an opportunity to contest such future mergers. If such a suit were started, the merger

could not be consummated until the conclusion of the suit. If no such suit should be started within 30 days, or if the Justice Department should be unsuccessful in its suit, the merger could then be consummated and the Justice Department could not thereafter attack it. And, consistent with the new objective of eliminating the unscrambling of bank mergers which had already been consummated, the bill would have exempted from the antitrust laws all mergers consummated up to the date of enactment.

This amendment was unanimously accepted by the Banking and Currency Committee, and after the defeat of an amendment to prevent the exemption from the antitrust laws from applying to the cases pending in court, it was passed by the Senate without opposition. It is now pending before the House Banking and Currency Committee, and hearings on it are beginning today.

Turning more particularly to savings and loan association mergers, it is appropriate to start by saying that Congress has not specifically considered this matter and no statutes specifically cover it. The Federal Home Loan Bank Board, however, has had a regulation in force since 1935, requiring approval of a merger of an insured savings and loan association. Until recently, savings and loan mergers did not create any problems under the antitrust laws. An industry whose total assets were small, made up of small, local, mutual associations, where mergers were unusual in any event, simply did not raise antitrust issues. In the 20 years since World War II, however, the problem has become increasingly significant. During this period the industry's savings accounts have increased from $7.5 billion to well over $100 billion. Though the number of savings and loan associations has not increased appreciably in the past 20 years, individual associations have grown tremendously in size and in number of branches. Furthermore, the increase in stock savings and loan associations has been of considerable importance. The number of mergers proposed rose to 40 during 1964, a substantial increase from previous years.

The application of the antitrust laws to savings and loan associations is somewhat different from the application of the antitrust laws to banking. The $100 billion of savings in savings and loan associations is not generally considered part of the money supply as are demand deposits. But I think economists are coming to see an increasingly close relation between savings—called quasi-money—and the demand deposits and currency—classed as money. Savings and loan associations do not have as long a history of Federal regulation and control. but these Federal controls are becoming more and more similar. Savings and loan associations do not have the same claim for exemption from the 1950 Cellar-Kefauver Antimerger Act, but as the Supreme Court has held that this exemption is no longer valid, this difference is no longer of any practical effect.

The similarities between banking and savings and loan associations are, in my judgment, greater than the differences. The degree of regulation, as I have said, is growing closer and closer. Both systems are backed up by federally sponsored insurance. Both systems are inextricably enmeshed in our economic system. And most important from an antitrust point of view, both banks and savings and loan associations are based on dual Federal-State systems, with 51 different sets of local organizations, no one of which can have branches outside its home State, and no one of which can get a nationwide monopoly.

Since February 19, 1965, the Federal Home Loan Bank Board has required applicants for mergers to submit considerable information as to their loans, their savings, and the market structure of the areas. This includes a map showing all savings and loan associations, savings banks, and commercial banks within 10 miles of the offices of the merging associations, a list of all financial institutions in the county and in the standard metropolitan statistical area where their home offices are situated, and the assets, savings accounts, and mortgage loans of the savings and loan associations and mutual savings banks, and the assets and savings accounts of each commercial bank within the same areas.

It would seem that with this information the Board would be in a good position to judge the effect of the merger on the competitive situation in the area principally affected. However, in some cases the competitive situation might be affected by competition for savings from organizations outside the 10-mile limit or the appropriate county or standard metropolitan statistical area. There might also be substantial competition for available mortgages from outside financial institutions, including such financial institutions as insurance companies. It might also be that in some cases the mortgage loan information for other institutions should be broken down into more detail in order to reflect competitive factors accurately.

The Federal Home Loan Bank Board is, from my knowledge of its members and its staff, firmly convinced of the benefits of sound and strong competition among savings and loan associations. And they are equally convinced of the desirability of sound and strong competition between savings and loan associations and all competing financial institutions—commercial banks, savings banks, mortgage banks, insurance companies, credit unions, and any other competitors there may be for savings or for loans.

Most of the proposed mergers which come before the Board will undoubtedly not involve any danger of monopoly or any tendency toward it or any danger of loss of competition or lessening of competition. And it may be expected that many of them will improve and strengthen competition by enlarging the resources and improving the services of institutions previously too small to provide the fullest or most satisfactory service.

June 2, 1982

Statement of the American Land Title Association
Before the Committee on Banking, Housing
And Urban Affairs of the United States
Senate on S. 1720

The American Land Title Association ("ALTA") appreciates the opportunity to present to the Senate Committee on Banking, Housing, and Urban Affairs its views on S. 1720, the Financial Institutions Restructuring and Services Act of 1981. Our comments focus principally on Title VI of the bill, which addresses the serious competitive and consumer problems that may result when financial institutions are allowed to exploit their control over the granting of credit to provide an unfair advantage to their insurance-related affiliates.

ALTA is the national trade association of the land title industry, with approximately 2,000 members located in all 50 states and the District of Columbia. Our members include local and national title insurance underwriters, as well as a great number of local title insurance agents and abstracters. The function of the land title industry is to guarantee the safe and efficient transfer of and investment in real property by purchasers and sellers, by mortgage lenders, and by those who purchase mortgage loans in the secondary market. ALTA is submitting these comments because we believe that the ability of the title insurance industry to fulfill these essential functions is threatened when

lending institutions control the issuance of title insurance policies in transactions in which they provide mortgage funds. The danger is both direct, because of inherent conflicts of interest that exist when mortgage lenders control title insurance agencies that will be making critical underwriting judgments on insurance policies issued in transactions in which they are involved, and indirect, because of the unique power mortgage lenders have in steering title insurance business to their captive affiliates and thereby foreclosing independent title insurance entities from access to the market. The inevitable result of permitting lenders to own title insurance entities to which they may steer their borrowers' transactions will be less competition, and significant harm to mortgage borrowers and to the healthy functioning of the secondary mortgage market.

Mr. Chairman, in recent sessions of Congress your Committee has recognized the serious adverse consequences that may ensue when lenders sell insurance. In 1980, H.R. 2255, which limited the ability of lenders to dominate the insurance industry, was unanimously reported to the Senate by the Banking Committee (after having been passed by an overwhelming margin in the House) and in 1981 the same bill was reintroduced as S. 207. These provisions have now been included as Title VI of S. 1720. ALTA strongly supports the concepts embodied in Title VI and agrees that there is an urgent need to adopt prohibitions on the insurance activities of all types of mortgage lenders.

Some groups have suggested, however, that the need for such limitations arises primarily in connection with the granting of commercial credit and that the problem is not as severe with regard to mortgage lending. In fact, quite the opposite is true. As will be discussed more fully below, the ability of a mortgage lender to steer title insurance business to a captive affiliate is far greater than the ability of commercial lenders to control the placement of other types of insurance, and the impact of such arrangements on competition and on the competitive opportunities of independent providers of title insurance is likewise far more severe. Moreover, serious conflict of interest problems exist when the grantor of mortgage credit controls the title insurance agency that will issue the title insurance policies to the lender and the purchaser in the real estate transaction -- conflicts that do not exist in the case of other types of insurance for which affiliates of lenders may be agents. For these reasons, ALTA urges the Committee to extend the limitations on insurance-related activities contained in Title VI of S. 1720 to embrace all types of lenders who make mortgage loans (including specifically savings and loan associations, their service corporations and their holding companies).

* * *

While there are a number of reasons why the competitive, consumer, and conflict of interest problems involved in lender-related insurance activities are particularly acute in the case of title insurance activities, there are three key factors that we wish to highlight for the Committee's consideration: (1) because of the nature of a real estate transaction (particularly a residential real estate transaction), the potential for voluntary tie-ins in the sale of title insurance by mortgage lenders is far greater than in the case of other types of insurance; (2) because of the nature of title insurance -- which is sold for a one-time premium, rather than on a periodically renewable basis as is the case with other types of insurance -- the impact of lender ownership of title insurance entities on the competitive opportunities of independent providers of title insurance is far more severe than may be the case with other types of insurance-related activities by lenders; and (3) because the functions and responsibilities of a title insurance agency in the underwriting and issuance of a policy of title insurance are far more substantive than the sales-related activities of other types of insurance agencies, the actual and potential conflicts of interest that lender-owned title insurance agencies face simply do not exist in the case of other types of insurance agencies that may be owned or controlled by lenders. Each of these factors is discussed in greater detail in the balance of this statement.

1. The problem of voluntary tie-ins is particularly acute in the case of title insurance.

Any time a lender who is in a position to grant or withhold credit has an ownership interest in an entity that can provide insurance related to that extension of credit, there is always the risk that the potential borrower's selection of a provider of such insurance may be tied to the lender's credit decision. This risk is particularly acute if the borrower is a consumer. While laws and regulations may prohibit lenders from explicitly tying the sale of insurance to the granting of the loan, as this Committee has recognized, and as several courts and industry commentators have observed,*/ even in the face of such prohibitions lenders that have ownership interests in insurance agencies have the ability to steer a substantial portion of their borrowers' credit-related insurance business to such agencies.

*/ See Tie-ins of the Sale of Insurance by Banks and Bank Holding Companies: Hearings on a Study By the Federal Reserve Board on Tie-ins Between the Granting of Credit and Sale of Insurance By Bank Holding Companies Before the Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. (1979); One Bank Holding Company Legislation of 1970: Hearings Before the Senate Comm. on Banking and Currency, 91st Cong., 2d Sess. (1970); Independent Insurance Agents of America v. Board of Governors of the Federal Reserve System, 658 F.2d 571 (8th Cir. 1981); Connecticut Bankers Association v. Board of Governors of the Federal Reserve System, 627 F.2d 245 (D.C. Cir. 1980); D. Leonard, Unfair Competition Under Section 106 of the BHCA: An Economic and Legal Overview of Conditional Transactions, 94 Banking L.J. 773, 786-7 (1977); W. Christopher, Banks and Bank Holding Companies, 34 ABA Antitrust L.J. 432, 457-8 (1970) (Remarks of R. Hammond).

A consumer who is anxious to secure the lender's favorable consideration of his loan application may readily agree to a suggestion or recommendation by the lender that he obtain insurance through the lender's affiliate in the belief that such a decision will enhance the prospects of his obtaining the loan. For several reasons, this problem of voluntary tie-ins is particularly acute in the case of title insurance.

First, whereas consumers purchase life, automobile, and property insurance with some frequency, most consumers purchase real estate (and hence title insurance) on relatively few occasions in their lifetimes. In the case of these other types of insurance, consumers have the time, ability and experience to become knowledgeable shoppers for such insurance or to utilize the services of an independent insurance agent or broker who can provide them with expert advice on their insurance needs, on which companies can provide the best coverage and prices, et cetera. On the other hand, because title insurance is purchased so infrequently (for most consumers it is purchased only at the time of the purchase of a home), consumers generally do not have the kind of familiarity with the title insurance market that they may have with respect to the market for other types of insurance.

Second, in the pressure-filled period between the time a consumer signs an agreement to purchase a home and the time he must make a decision on the selection of a title company to handle the transaction, he is generally so

preoccupied with other important concerns (such as obtaining mortgage financing, arranging to move, or selling his existing home) that it is virtually impossible for him to devote the necessary time to become a knowledgeable shopper for title insurance services. Accordingly, most consumers inevitably rely on the advice or recommendations of the knowledgeable and experienced real estate professionals with whom they are dealing in the transaction (particularly the mortgage lender) in selecting a title company. In this setting, the ability of a mortgage lender to steer the consumer to the title company it owns or otherwise to engage in a voluntary tie-in is particularly great.

Third, developments in the mortgage market in recent years (specifically the reduced availability of mortgage funds and the proliferation in the types of mortgage loans that lenders may make) have tended to enhance the willingness of mortgage borrowers to accept the recommendations of mortgage lenders on the selection of ancillary service providers in real estate transactions. When a consumer is seeking a hard-to-get mortgage loan from a particular lender, or is negotiating with that lender on the terms of the loan, the mere suggestion by that lender that the consumer utilize the services of the title company affiliated with the lender may be readily accepted by the applicant in the belief that the prospects of his obtaining a loan (or obtaining the type

of loan that he would like) will be enhanced if he "accomodates" the lender by selecting its affiliated title company.

In sum, because consumers lack the time, experience, and knowledge to shop on their own for title insurance, they will invariably look to the mortgage lender, real estate broker or other real estate professional in the transaction for a referral or recommendation of a title company. As noted by the Department of Housing and Urban Development in its recent report to the Congress under Section 14 of the Real Estate Settlement Procedures Act, over 80 percent of consumers select a particular title company on the basis of a recommendation by a lender or other real estate professional in the transaction.*/ Because of this reliance, the risks of voluntary tie-ins is far greater in the case of title insurance than with other types of insurance. As HUD has observed:

> In some instances, especially with lenders, the "recommendation" of a particular title company is so strong that it becomes a requirement; but as a practical matter the distinction is probably not very important, for even a fairly mild recommendation by one of these third-party influences is very likely to be accepted by the lay party to the transaction. [Emphasis added.]**/

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*/ See Report to the Congress on the Need For Further Legislation in the Area of Real Estate Settlements, Appendix Ch. II, p. 9 (June 1981) ("HUD Report").

**/ HUD Report, supra, at Appendix, Ch. III, p. 64.

When the grantor of mortgage credit has the ability to place a significant portion (if not all) of its borrowers' title insurance business with a title company in which it has an ownership interest, the ability of independent title companies to compete for that business is effectively foreclosed. As discussed in the next section of this statement, the extent of this market foreclosure is far greater than may be the case in other lines of insurance. Indeed, if a substantial number of major mortgage lenders are permitted to establish captive title companies to which they may refer their borrowers' business, competition in the provision of title insurance services may be effectively eliminated.

2. Because title insurance differs from other types of insurance that are renewable on a periodic basis, independent title companies may be totally foreclosed from the market by lender-owned title companies.

There is no question that when a lender owns an insurance agency to which it may refer the property/liability insurance business arising from its lending operations, there is an adverse impact on the ability of other insurance companies for which the affiliate of the lender is not an agent and on independent agencies to compete for that business. Nevertheless, for several reasons these other insurers and agencies will not be totally foreclosed from access to the market or from opportunities to compete for business.

First, a substantial market exists for the sale of property/liability insurance that is independent of the market for property/liability insurance sold in connection with loan transactions. In this market, lenders cannot use the leverage provided by their ability to grant or withhold credit to favor their affiliated insurance agencies.

Second, many consumers have had substantial experience in the purchase of property/liability insurance and can seek the assistance of independent agents or brokers in obtaining advice on the purchase of such insurance. Accordingly, consumers can easily shop elsewhere for property/liability insurance even if the lender recommends the purchase of such insurance from the lender's affiliate.

Third, even if the consumer's purchase of a property/liability insurance policy is explicitly or implicitly tied to the granting of credit, immediately after the loan transaction is consummated other property/liability insurance companies or agencies can still attempt to convince the consumer to switch his coverage to another company and to obtain a refund on his existing policy for the unexpired term of the policy.

Finally, because property/liability insurance is renewable on a periodic basis by the payment of an additional premium, all other property/liability underwriters and independent agencies still have the ability to compete for the consumer's patronage at the time the consumer's original policy comes up for renewal.

Because these competitive opportunities are still effectively available to independent insurers and agencies, lender-owned property/liability insurance agencies must remain competitive with the independents in the scope of the insurance coverage they provide and in the rates they charge to captive borrowers.

These competitive opportunities -- and the competitive restraints that are thereby placed on lender-owned agencies to provide quality service, broad policy coverage, and reasonable rates -- simply do not exist in the case of title insurance. First, title insurance is almost invariably purchased only in connection with a real estate transaction and almost all real estate transactions involve the participation of a mortgage lender. Thus, unlike the situation with respect to property/liability insurance, if mortgage lenders are allowed to refer the title insurance business arising in connection with their loan transactions to their title insurance affiliates, there is virtually no market for title insurance apart from such loan transactions that independent title insurance entities can compete for.

Second, as discussed above, consumers do not have the time, experience, or ability to shop knowledgeably for title insurance the way they can shop for property/liability insurance, and will rely on the recommendation of a mortgage lender in the selection of a provider of title insurance services to a much greater extent than they may rely on the

lender's recommendation of a property/liability insurance agency or company. Accordingly, the ability of independent title companies to compete for the consumer's patronage in a real estate transaction in the face of a recommendation or referral by the mortgage lender in the transaction is far more limited than the ability of an independent property/liability insurance agency to compete for the same consumer's property/liability insurance business.

Third, because the major portion of the one-time premium paid for title insurance is devoted to risk identification and risk elimination activities that are undertaken before the policy is issued (such as the search and examination of the title, and the determination of those liens, claims, and encumbrances affecting the title that can be insured against or those that must be noted as exceptions to the policy's coverage), a consumer who finds that he could have obtained better coverage, service, or rates from an independent title company cannot "switch" insurers after the transaction has been consummated and obtain a refund of the premium paid to the lender-owned title company. This differs significantly from the case of property/liability insurance where the bulk of the premium is used to provide financial indemnity against future unknown risks and losses that may arise during the term of the policy, and where a refund of the unused portion of the premium may be obtained if the policy is cancelled before the expiration of its term.

Finally, unlike property/liability insurance (which must be renewed periodically for an additional premium), title insurance is issued for a one-time premium and provides protection in accordance with the terms of the policy for as long as the insured — or his heirs or devisees — has an interest in or liability with respect to the property. Because a title insurance policy is not renewed periodically, there is no "renewal" business for which independent title companies can compete. If a mortgage lender has effectively steered the title insurance business in a mortgage loan transaction to its captive title insurance agency, the next competitive opportunity independent title companies have to insure that property will arise only when the property is resold. Of course, at that time a mortgage loan probably will be involved in the transaction and if there is a new mortgage lender with a captive title company, independent title companies will face the same market foreclosure problems.

Thus, in light of the foregoing characteristics of the market for title insurance, it is clear that the ownership of title companies by mortgage lenders presents far more severe problems of market foreclosure than in the case of lender ownership of other types of insurance agencies. The long-term effects of such market foreclosure are clear. Independent title companies will be driven from the market as the number of transactions for which they can effectively compete declines in direct proportion to the increase in the

growth of lender owned or controlled agencies. (It should be noted that the loss of business opportunities to independent title companies will not be attributable to the quality of their products or services or the reasonableness of their prices, but will be a function of the power that mortgage lenders have to steer their borrowers' title insurance business to their affiliated title companies.) Because these captive companies can obtain business by virtue of the referrals of their lender-owners (who have a strong financial interest in sending business to them), they are, to a great extent, insulated from the rigors of having to compete for business in the marketplace on the basis of their products, services, and rates. The consumer consequences when captive or controlled title companies are insulated from competition in this manner have been accurately described by the Antitrust Division of the Department of Justice:

> To sum up the major evils of controlled title companies, where a real estate settlement producer [such as a mortgage lender] is able to direct the purchaser of a title insurance policy to a particular title company and at the same time that producer owns the title company, the purchaser is likely to end up (1) paying unreasonably high premiums, (2) accepting unusually poor service, or (3) accepting faulty title examinations and policies from the controlled title company. */

*/ Department of Justice, The Pricing and Marketing of Insurance, p. 273 (1977).

3. <u>A title insurance agency owned by a mortgage lender faces serious conflicts of interest that do not exist in the case of other types of insurance agencies that may be owned by lenders.</u>

In the two previous sections, we have discussed the reasons why there is a great risk of voluntary tie-ins in the case of lender-owned title insurance agencies and the reasons why lender ownership of title insurance agencies poses greater problems of market foreclosure for independent title companies than may be the case in other lines of insurance. There is, however, a third area of concern that the Committee should be alerted to — the potential conflicts of interest that a lender-owned title insurance agency is inevitably subject to when it issues title insurance policies in real estate transactions in which the affiliated lender provides mortgage funds. To understand the seriousness of this problem, one must understand the functions performed by a title insurance agency in a real estate transaction.

In the case of most other types of insurance, the insurance agent performs what is essentially a sales function for the underwriter and makes few, if any, discretionary judgments that affect the underwriting of the risks to be assumed. In the case of property/liability insurance, for example, the agent only has to determine the proper classification for the property to be insured (usually based on a few objective factors determined by the underwriter, such as

the building material of the house, its distance from a fire hydrant, the existence of smoke detectors, et cetera) and then determine the appropriate premium from the underwriter's rate manual. The responsibilities and functions of a title insurance agent, on the other hand, are far more substantive and involve discretionary judgments that affect the various -- and frequently conflicting -- interests of the buyer, the seller, the mortgage lender, the purchaser of the mortgage loan in the secondary market, and the underwriter who will be liable under the policy that is issued by the agent.

Among its various responsibilities in the issuance of a title insurance policy, a title insurance agent must:

- conduct (or cause to be conducted) a search and examination of the land title records to ascertain the state of the title and the liens, claims, and encumbrances that may affect the rights that the seller is in a position to convey and that the buyer will obtain upon the closing of the transaction, and to ascertain whether the mortgage lender will have a valid and enforceable lien to secure its mortgage loan;

- make sound and prudent underwriting judgments regarding the scope of insurance protection that can be provided in the transaction and which liens, claims, and encumbrances must be noted in the title insurance policy as affecting the interests of the insured purchaser and mortgage lender; and

- in those areas of the country where title insurance agencies handle the closing of the transaction, accurately handle the closing, including the disbursing of funds, paying off existing liens, et cetera.

In light of the substantive functions performed by the title insurance agent -- functions that affect the diverse interests of all of the parties in the transaction -- actual and potential conflicts of interest exist when the title insurance agent is owned or controlled by the mortgage lender in the transaction. A few examples will make this point clear.

First, there may be a conflict between the interests of the purchaser of the property and the interests of the mortgage lender. While the mortgage lender is essentially interested only in the validity, priority, and enforceability of its mortgage lien, the purchaser of the property has a much broader interest in the bundle of rights (i.e., the state of the title) he will be acquiring in the transaction. Many title-related matters that may affect the purchaser's use or enjoyment of the property (such as the existence of certain easements or restrictions, or the location of fence lines) are of little or no interest to the lender if they do not affect the value of the property to such an extent that the value of the mortgage lien will be threatened. Accordingly, when the mortgage lender controls the title company in the transaction, there is a serious question whether the separate and distinct interests of the purchaser will be adequately safeguarded once the lender-controlled title company is satisfied that the lender's interest has been adequately protected.

Second, because the lender will be a named insured under a mortgagee title insurance policy issued in the transaction, a lender-owned title insurance agency faces an inevitable conflict in making underwriting judgments between its interest in providing its lender-owner with the maximum degree of insurance protection and its responsibilities to its underwriter to underwrite only reasonable and prudent risks. Anytime a potential insured has the power to control the discretionary judgments regarding the scope of insurance protection that the underwriter will be committed to, this conflict of interest inevitably exists.

Finally, the issuance of title insurance policies by an agency that is owned or controlled by the mortgage lender in the transaction may have serious repercussions on the secondary mortgage market. The growth of the secondary mortgage market has been facilitated in great measure by the fact that purchasers in that market have been able to rely on the safety and soundness of the titles underlying the billions of dollars of mortgage loans they purchase because of the professionalism and independence of the title insurance agencies and underwriters who have searched, examined, and insured those titles. In contrast, when the title insurance agency that has searched and examined the title, and issued the title insurance policy on the mortgage loan, is affiliated with the mortgage lender that is seeking to sell that loan in the secondary market, the purchaser of

such loans must inevitably be concerned over whether the lender's desire to ensure the marketability of the loan has affected the quality and integrity of the title insurance underwriting. To the extent that this concern is reflected in an increased perception of the risks involved in purchasing such loans, the continued availability of the enormous financial resources made available for mortgage lending through the operation of the secondary mortgage market will be impaired.

CONCLUSION

While the Committee has recognized the necessity of imposing reasonable limitations on the insurance-related activities of bank holding companies, for the reasons discussed above (i.e., the greater risk of voluntary tie-ins, the possibility that independent title companies will be totally foreclosed from competitive opportunities, and the serious conflicts of interest that arise when mortgage lenders own or control the title insurance agencies that issue title insurance policies in transactions in which their affiliated lenders are involved), ALTA believes it is absolutely imperative that the limitations contained in Title VI of S. 1720 be adopted with respect to the title insurance-related activities of bank holding companies.

Indeed, in light of the foreclosing discussion we believe that the public interest requires that the same

limitations be placed on all financial institutions that make mortgage loans, including specifically service corporations of savings and loan associations, the associations themselves, savings and loan holding companies, and savings banks. Because a far greater number of mortgage loans are made by the thrift industry than by commercial banks, there is an even greater need for reasonable limitations on the title insurance-related activities of these institutions than in the case of bank holding companies. The need for uniform rules in this area that will be applicable to all mortgage lending institutions is particularly acute in light of the rapidly changing financial and regulatory environment in which the distinctions between the functions of thrift institutions and commercial lenders is being eliminated.

We also believe that the exemption provided for insurance agency activities of bank holding companies (or other lending institutions) with assets of $50 million or less should not apply to title insurance agency activities. The consumer, competitive, and conflict of interest problems discussed above exist to the same extent whether the mortgage lender (and its affiliated entities) has assets below or above the $50 million level and the same limitations should apply regardless of the size of the lending institution.

ALTA appreciates the opportunity to submit its views on Title VI of S. 1720 and urges the Committee to adopt the

modifications we have suggested — particularly our recommendation to expand the provisions of Title VI to embrace all financial institutions that make mortgage loans."

REMARKS OF

ALAN R. COHEN

ACTING SUPERINTENDENT OF BANKS

NEW YORK STATE BANKING DEPARTMENT

Thank you for the opportunity to express the views of the New York State Banking Department on S. 2531, the "Capital Assistance Act of 1982" and S. 2532, the "Regulators Bill".

The New York State Banking Department is responsible for regulating state-chartered domestic and foreign commercial banks, thrift institutions, credit unions and numerous other financial service organizations operating in New York State. We have been performing this role for well over a century and regard our close proximity to the organizations we regulate and the markets they serve as fundamental to our efforts to supervise the multi-faceted New York banking system effectively.

As you know, this Department has been and continues to be committed to the belief that the thrift industry both in this state and nationwide plays an extremely important economic and social role and should be given the level of governmental support necessary to permit it to adjust to, and ultimately survive, the current financial crisis which has been the result of dramatic and unforeseen changes in economic conditions in recent years.

Comments on S. 2531

There are a number of aspects of S. 2531 that are of substantial concern to us. We will first list these concerns, then elaborate on each of them and make specific recommendations for amendments to S. 2531 to deal with these issues.

1. The bill provides only a partial offset to the operating losses of the thrifts. Our analysis of New York thrifts indicates that this would extend the life-span of these institutions only briefly. The formula for capital assistance in S. 2531 is therefore clearly inadequate to deal meaningfully with the financial problems of the thrifts.

2. The bill involves a Faustian bargain since, as a condition of receiving assistance, the institution must agree to all terms and conditions set by the insuring agency. This gives the insuring agencies virtually unlimited power, by regulatory fiat, to restructure the thrift industry without meaningful Congressional policy guidance.

3. The bill removes the primary state regulator from any participation in efforts to save troubled institutions, overrides fundamental state constitutional and statutory provisions, and raises serious questions regarding the fiduciary responsibilities of trustees and directors.

Each of these points will be elaborated on below.

Partial Offset to Losses

S. 2531 establishes a sliding scale of capital assistance for thrift institutions and requires solvency for more than six months as a condition of assistance (and, presumably, as a condition of continued assistance). Our analysis of these provisions, as they affect New York thrift institutions, indicates that they would extend their life-span only briefly.

We examined the 20 New York state-chartered savings banks (aggregate assets of over $31 billion) which, based upon projecting their operating losses during the first quarter of 1982, are closest to exhausting their net worth in the absence of any financial assistance. Of these 20 banks, 13 would exhaust their net worth by year-end 1983 and the rest would do so by July 1984 if there were no assistance. Eleven of the 20 banks already have a net-worth-to-assets ratio below 3% and the rest will fall below 3% by the end of 1982 if the rate of loss they experienced during the first quarter of 1982 continues. All 20 banks meet all the other qualifications for assistance set forth in S. 2531.

If the sliding scale formula in S. 2531 is applied to these 20 banks, based on projecting their operating losses and deposit experience during the first quarter of 1982, this would extend the time when they reach zero net worth by only nine months, on average (median), as compared with when they would reach zero net worth if they received no assistance. Seventeen of these 20 institutions would have their time extended by less than one year (see Table 1).

While these figures relate to the experience of New York thrifts, there is no reason to believe that a materially better situation would prevail for thrifts throughout the country.

A similar analysis was made of the five New York savings banks * which have been merged for supervisory reasons during the past seven months, based on projecting their operating losses and deposit

* These were Greenwich, Union Dime, Central, Western and New York Bank for Savings.

[illegible]

Name of Savings Bank	Total Assets 1/31/[illegible] (Million $)	Net Worth 1/31/[illegible] (Million $)	Date of [illegible] of the [illegible] [illegible] Quarter of [illegible]: [illegible]	[illegible]	[illegible] # of Months [illegible] of Net Worth
[illegible]	$ [illegible]	$ [illegible]	April '[illegible]	[illegible] '[illegible]	9 months
[illegible]	[illegible]	132	[illegible] '93	[illegible] '95	*
[illegible]	1,330	46	March '[illegible]	May '[illegible]	14
[illegible]	4,127	[illegible]	[illegible] '[illegible]	[illegible] '[illegible]	11
[illegible]	2,522	71	May '[illegible]	[illegible] '[illegible]	3
[illegible]	[illegible]	40	[illegible] '93	June '[illegible]	8
[illegible]	[illegible]	42	[illegible] '[illegible]	Sept. '[illegible]	9
[illegible]	[illegible]	34	[illegible] '93	June '[illegible]	22
[illegible]	419	[illegible]	[illegible] '[illegible]	[illegible] '[illegible]	5
[illegible]	[illegible]	4	[illegible] '[illegible]	[illegible] '[illegible]	[illegible]
[illegible]	[illegible]	34	May '[illegible]	March '[illegible]	20
[illegible]	[illegible]	1	[illegible] '[illegible]	Sept. '[illegible]	8
[illegible]	143	12	May '[illegible]	June '[illegible]	23
[illegible]	[illegible]	14	July '[illegible]	June '[illegible]	11
[illegible]	671	[illegible]	Sept. '93	June '[illegible]	9
[illegible]	179	[illegible]	July '[illegible]	June '[illegible]	11
[illegible]	[illegible]	51	March '[illegible]	Sept. '93	6
[illegible]	135	3	May '[illegible]	Sept. '[illegible]	16
[illegible]	[illegible]	19	[illegible] '[illegible]	[illegible] '[illegible]	7
[illegible]	2,[illegible]	65	May '[illegible]	Feb. '[illegible]	9

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experience during the last full quarter of their existence prior to merger. Applying the sliding scale formula in S. 2531 would have extended the time when they would have reached zero net worth by only eight months, on average, as compared with when they would have reached zero net worth without any assistance. All would have had their time extended by less than 11 months.

In light of these facts, it is clear that the formula for capital assistance is inadequate to deal meaningfully with the thrifts' problem of continued operating losses and rapidly declining net worth positions. We note that the bill does enable the insuring agencies to establish criteria for assistance that are different from those set forth in the formula. It is not clear, however, whether and to what extent the insuring agencies would, in fact, go beyond the limits of the formula.

Under the circumstances, we would favor an approach such as is employed in H.R. 6267 which incorporates a procedure for maintenance of net worth at a 2% level. Such an approach has greater potential for buying additional time for interest rates to decline -- which is the most effective, practical solution to the problems of the thrifts -- and thereby enable thrifts to return to profitable operations.

Conditions for Receiving Assistance

S. 2531 states that, as a condition of receiving assistance, the institution must agree to all terms and conditions set by the insuring agencies.

This, in effect, provides a "blank check" to the insuring agencies to restructure the thrift industry of the United States by regulatory fiat without meaningful Congressional guidance, enabling the insurers to accelerate interstate and interindustry mergers.

If such fundamental changes in the country's banking structure are to occur, it should be only after careful and thoughtful consideration by Congress and/or State legislatures.

We recognize, of course, that under certain circumstances the only merger alternatives for a failing bank may be across state lines or across industry boundaries. However, we believe that good-faith efforts should first be made to arrange intra-state mergers with other thrifts. We therefore urge that any final legislation that emerges from this Congress include a requirement that both FDIC and FSLIC make a reasonable effort to authorize mergers in the following order of preference (as is presently provided for FSLIC-insured institutions in bills S. 1720, S. 2532 and H.R. 4603):

1) Institutions of the same type within the same state;
2) Institutions of the same type in different states;
3) Institutions of different types in the same state;
4) Institutions of different types in different states.

Role of State Regulators

S. 2531 provides no role for the primary state regulator and permits the federal insurers, without consulting with state regula-

tors, to establish terms and conditions of assistance including adoption of plans of operation and restrictions on operations.

We believe that federal consultation with state regulators is essential. Without wishing to appear immodest, we believe we know more about the chances for survival of New York state-chartered institutions than anyone at the federal level. We are in constant communication with the institutions we regulate. We have been keeping track records, generating computer models and monitoring deposit levels long before it was publicly acknowledged that there was a "thrift problem". We know the management capability and the competitive situation, intra-industry and inter-industry, in our communities. This is undoubtedly true for state regulators in other states as well.

In recent months, we have, in conjunction with the Federal Deposit Insurance Corporation, consummated several major mergers between New York-chartered savings banks. These mergers were effected with the full cooperation of the trustees of all of the institutions involved. */ As a result of these mergers, a primary goal of the New York State Banking Department in the current crisis in the thrift industry -- the effectuation of intra-state mergers between institutions of the same type -- has been achieved.

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*/ It was not necessary to require the management of the foregoing institutions to formally "sign away" such institutions to their regulators (state or federal) in advance of the need to effect a merger. In New York, such action conflicts squarely with the responsibility of savings bank trustees to depositors and creditors to entrust the bank's assets to a successor corporation that they have had a role, however limited, in choosing.

in response to concerns about the safety and soundness of an institution, is unable, for example, to enforce cease and desist orders limiting a bank's deposit-taking activities or is unable to take possession of an insolvent institution, a bill designed to help extend the life of troubled institutions will have had the effect of removing a bank's primary regulator from any meaningful role in dealing with a failing institution. The resulting loss of the state regulator's in-depth knowledge of local institutions, financial conditions and community needs would not in any way contribute to achieving the Act's purpose.

Narrowing of the preemption section is therefore needed to insure that its only effect is to allow all otherwise qualifying institutions to participate in the program regardless of the provisions of state law.

It would also deprive state regulators of a valuable tool in dealing with problem banks. As indicated previously, we are attempting to promote the concept of pre-supervisory mergers which, as we have indicated, could save the insuring agencies hundreds of millions of dollars. To preempt state law would therefore be counter-productive since it would eliminate state authority to induce the sorts of mergers that would be helpful in dealing with the longer range problems of the thrifts.

The preemption also raises serious questions regarding the fiduciary responsibilities of trustees and directors and does not address their potential personal liability or that of other individuals who must act to accept deposits or declare dividends.

beneficial, since our experience in New York has been that such provisions provide a useful means by which to insure management and trustees' perception of their public responsibility.

Support for the Mortgage Market

If necessary support for this legislation is to be achieved, the usefulness of thrift institutions in American society must be recognized. In our view, they must continue to be, as they have been in the past, the principal source of home financing for the American family.

We therefore urge that S. 2531 include a requirement that, as a condition of assistance, the institution must agree to invest 60% of its net new deposits in residential mortgages. The only exception to this 60% requirement should be those thrifts that have engaged in heavy borrowing to meet liquidity requirements or to cope with deposit outflows. They should be allowed to ease the strain they are currently experiencing by using net new deposits to reduce this indebtedness.

Proposed Amendments to S. 2531

To summarize, for the reasons indicated above, we believe that S. 2531 should be amended to:

1. Provide for capital assistance which would maintain net worth at a 2% level as in H.R. 6267.

2. Require both FDIC and FSLIC to make a reasonable effort to authorize mergers in the order of preference set forth in S. 1720, S. 2532 and H.R. 4603.

3. Provide a meaningful role for the primary state regulator in dealing with failing institutions by requiring good-faith consultation with the appropriate state regulator, from initial discussion to final implementation, in establishing and changing the terms and conditions for receiving assistance, and before taking any action under the provisions of this bill.

4. Narrow the preemption section to insure that its only effect is to allow all otherwise qualifying institutions to participate in the program regardless of the provisions of state law.

5. Require that 60% of net new deposits in assisted institutions be invested in residential mortgages or be used to reduce heavy indebtedness.

6. Retain state law provisions concerning fiduciary responsibilities of trustees and directors.

We believe that adoption of such amendments would more effectively deal with the serious financial problem of thrift institutions, would be in harmony with the concept of the dual banking system, would tap the experience and knowledge of the primary state regulator, would help ensure the continued commitment of the thrift industry to the housing market and would avoid placing trustees and directors in an extremely precarious position in terms of their fiduciary responsibilities.

Comments on S. 2531

Our major concerns regarding S. 2531 are that it fails to provide an adequate role for the state regulators; gives the FDIC excessive powers that are unnecessary and that undermine the authority of state regulators; overrides state constitutions and laws; and neglects to require the FDIC to make a reasonable effort to authorize mergers in the order of preference discussed previously. Our comments below elaborate further on these issues.

S. 2531 is the latest draft of the Regulators' Bill. The Regulators' Bill was first proposed by the Federal Financial Institutions Council in the spring of 1981. Since then it has undergone several redrafts. The House passed a version of the bill, H.R. 4603, in October of 1981, and a similar version is included in S. 1720. The Regulators' Bill was conceived and promoted in the belief that broader, more flexible powers and specific policy direction from Congress would be desirable to enable federal regulators to deal with the severe problems of the financial system which have been caused by extraordinarily high interest rates.

The New York State Banking Department, in testimony before this Committee on October 28, 1981, recognized the seriousness of the problem and supported enhanced powers for federal regulators. Former Superintendent Muriel Siebert testified that . . .

> "I am sanguine that the expanded ability of federal insurers to assist troubled institutions will make such mergers easier to achieve.
>
> I do not want to rule out any accommodation that will strengthen the banking system. However, in the first instance every effort should be made to effect in-state thrift-to-thrift mergers before resorting to other

> potential combinations. The configuration of banks and thrift institutions will, as I have said, evolve and change in the years ahead. In all likelihood, inter-industry and interstate mergers will occur as economic and competitive conditions change and when new banking legislation makes this possible."

That testimony also stressed that state regulators should be adequately involved in the process "from initial discussion to final implementation" but that the bill then under consideration failed to provide for this:

> "In addition, any 'emergency' legislation to expedite mergers and acquisitions should mandate the involvement of state regulatory authorities, throughout the process, from initial discussion to final implementation. I note that Section 165 of S. 1720 provides for 'consultation' by the FDIC, but only after an institution has gone into receivership. It is too late for a state regulator to become involved at that point since no one wants the institution to remain closed while other more creative approaches are developed. Clearly, this does not assure adequate representation and input by state representatives at all stages of the procedure. Because we deal with a smaller universe than federal regulators, we, quite naturally, have a more intimate knowledge of that universe. We know local conditions and the local marketplace well; and, because we know it, we can render valuable assistance to federal regulatory bodies when they are considering partners for troubled institutions."

Since that testimony, the Department has worked closely with the FDIC in arranging the successful open bank, assisted mergers of five state-chartered savings banks, with assets of over $9 billion. These mergers were accomplished in a cooperative manner which utilized the best resources of both state and federal regulators.

We are therefore disappointed that the latest draft of the Regulators' Bill, as contained in S. 2532, has moved beyond the scope of granting necessary emergency powers to federal regulators to an attempt to completely eliminate the states' role in regulating savings banks, many of which have been regulated by New York State for over 100 years.

Prior to 1978, there was no provision for a federal savings bank. Title XII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 allowed existing state-chartered mutual savings banks to switch to a federal charter, issued by the Federal Home Loan Bank Board. Federal mutual savings banks were specifically barred from converting to stock form. All of the drafts of the Regulators' bills have allowed conversion to stock form under certain circumstances.

However, S. 2532 breaks new ground in Section 102(2)(F) by giving the FDIC carte blanche to <u>require</u> a state-chartered savings bank to switch to a federal stock charter if the Corporation determines "that severe financial conditions exist that threaten the stability of a savings bank insured by the Corporation and that such a conversion or charter is likely to improve the financial condition of a savings bank." The FDIC would thereby become the primary regulator, as well as insurer, of these banks.

We can see no valid policy reason for this broad grant of authority to the FDIC, which was not included in earlier drafts of the bill. Such a grant enables the FDIC, at its discretion, to dismantle by fiat the dual banking system. The Banking Department strongly objects to this provision.

The Department has several other concerns with S. 2532, which we will address in sequence.

Section 101. The Department supports broader 13(c) powers for the FDIC and we recognize the need for broad discretion to be accorded to the FDIC. At the same time, we are concerned that this power may not be used in appropriate circumstances. The Department suggests that the Committee include strong language in the Committee Report which indicates its intent that this power be utilized. Further, the Department suggests that Section 101(6) be amended to require the FDIC to detail, on a case by case basis, when assistance under this broader 13(c) power was requested and why the granting of such request was not considered appropriate by the Corporation.

Section 102. - Addressed earlier in this document.

Section 103. Subsections (n), (o) and (q) exempt insured Federal savings banks (but not insured state savings banks) from certain regulatory requirements concerning mergers and the antitrust review thereof, loans to affiliates and insiders, and changes in control. This preference in favor of Federal savings banks does not appear necessary to accomplish the broader purposes of S. 2532. We recommend that any exemption of this type be extended to State savings banks on the same basis as Federal institutions.

Section 106. Our major concern regarding the emergency acquisition powers of Section 106 and Section 203 are that they fail to provide an adequate role for the State regulatory authorities.

Both Sections 106 and 203 of S. 2532 permit the federal insurers to override state objections to the exercise of their extraordinary

authority in connection with out-of-state takeovers of state-chartered institutions. We recommend that these provisions be modified by, at a minimum, adding sections such as those contained in H.R. 4603 which limit the insurer's authority to situations in which the insurer was appointed receiver of a closed bank; which provide an opportunity for in-state bidders to match the most favorable out-of-state bids; and which allow for the participation of state regulators in the bid solicitation procedures if state-chartered institutions are in receivership.

Furthermore, the possibility that state regulators may be given as little as 24 hours to object to the use by the Federal insurer of the extraordinary authority contained in Section 106 is unacceptable. A "reasonable opportunity" to object certainly envisions a period far greater than 24 hours when one considers the significant issues that would have to be considered in any situation in which Section 106 authority is utilized.

Finally, the preferred sequence of mergers and acquisitions set forth in Section 203 applies only to FSLIC-insured institutions. We know of no reason why a similar sequence should not apply to FDIC-insured institutions under Section 106. We suggest that Section 106 be amended to include this preference, as we proposed in our earlier comments on S. 2531.

Section 201. This section gives the Federal Home Loan Bank Board the power to authorize (and in the case of a Federal association, require) the conversion of mutual institutions into stock form when certain emergency conditions exist without regard to any state law or constitution. These provisions are drastic in nature in that they preempt part of the New York State Constitution which

restricts savings institutions to the mutual form of organization. The Department, the Governor and the New York Legislature have all expressed support for a constitutional amendment to allow stock conversions. However, the constitutional amendment process is lengthy and final action is not possible until November, 1983 at the earliest.

Given the present financial condition of the thrifts, the only practical effect of stock conversion at the present time would be to facilitate interindustry mergers which, we have previously indicated, should be considered only after reasonable efforts have been made to arrange intraindustry mergers.

Since we believe, based upon our experience in New York, that there are adequate opportunities for intraindustry mergers, we do not see any immediate,pressing need for stock conversions.

In view of this and since we are opposed to the concept of federal overriding of state constitutions, we recommend that the effective date of Section 201 be two or three years from the date of enactment of this bill in order to allow states adequate time to consider whether they wish to amend their constitutions and, if so, to permit them time to do so.

Section 302. This section, which relates to credit union mergers, similarly causes concern because of the lack of state participation. Although this Section does mandate that the National Credit Union Administration Board attempt to effect merger between two credit unions in the first instance, it also provides that if such efforts prove to be unsuccessful, the Board

may authorize any institution whose accounts are insured by the FDIC or FSLIC to purchase any of the assets or assume any of the liabilities of an endangered credit union. Such authorization may be granted without any consultation with the state regulator and regardless of any provision of state law.

Once again, we strongly urge that S. 2532 be amended to require that state regulators be consulted and be given an active role in any situation in which the disposition of the assets and liabilities of state-chartered credit unions is at issue.

Concluding Comments

The New York State Banking Department strongly supports the concept of providing capital assistance to banking institutions. However, for the reasons discussed previously, the present provisions of S. 2531 and S. 2532 are deficient in a number of respects. The formula for assistance in S. 2531 is not adequate to deal meaningfully with the problem and it is not clear whether and to what extent the insuring agencies would go beyond the limits of the formula.

We urge that the bills be amended to provide for maintenance of capital at a certain level; to give primary state regulators a meaningful role; to require both FDIC and FSLIC to make a reasonable effort to authorize mergers in the order of preference discussed previously; to narrow the preemption section to insure that its only effect is to allow otherwise qualifying institutions to participate

in the program; to require that a certain percentage of net new deposits in assisted institutions be invested in residential mortgages or to reduce heavy indebtedness; and to incorporate the other provisions suggested earlier in this testimony.

We appreciate the opportunity to present our views and stand ready to provide any additional assistance requested by this Committee.

WESTERN INDEPENDENT BANKERS

[illegible]

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Page 2
The Honorable Jake Garn
Washington, D. C.

June 23, 1982

recall how, over the decades, the policies of thrift institutions were to be over loaned, over built and under priced, often to the applause of their Federal regulators and many members of Congress. While it seems somewhat incredible to bail out managerial deficiencies with Federal programs, the public interest has certainly become involved. We agree with the provision of S. 2531 which ties assistance to a percentage of loss rather than a capital maintenance program. It seems to us that this short term assistance should be accompanied by some more stringent long term requirements involving liquidity, beginning capital, and retained earnings. Also, we believe, it would be reasonable to tie such assistance to requirements limiting fixed asset investments, costly branching programs and engaging in various unprofitable services. Since commercial banks whose net worths might approach the 3% mark have long since been closed or merged, we do not have the interest to aggressively support this legislation. Realizing, however, that failing financial institutions of all type adversely affect the welfare of the economy and of commercial banks in many ways, we do not oppose S. 2531.

Yours very truly,

William G. Wolford
Chairman
W.I.B. Legislative Committee

WGW/kb

WESTERN INDEPENDENT BANKERS

[illegible]

June 24, 1982

Dear Senator or Congressman:

Sometimes it is worth [illegible] to point out that there are two principal associations of independent banks in the United States. Because of misleading press coverage or [illegible] made by one association or the other, congressmen and public [illegible] frequently and incorrectly assume that the information received represents the position of all independent banks in the U.S. Such is not the case.

Western Independent Bankers (WIB) is an association representing independent banks located in the Western states including Alaska and Hawaii. This constitutes [illegible] banking organizations controlling $31 billion in [illegible].

The other association of exclusively independent banks in the Nation is the Independent Bankers Association of America (IBAA) representing approximately [illegible] banks. These banks are located primarily in the East and Mid West.

The two organizations, of course, are in agreement on many issues and policies but important philosophical differences do exist. Perhaps some reason these differences occur is because WIB members are located primarily in branch banking states and generally believe in the economic and public service benefits of branch banking. IBAA has historically championed the cause of unit banking to the exclusion of branch banking.

Most recently differences have been evident in the issue of interest rate deregulation. IBAA has opposed allowing the market to set savings rates while WIB has enthusiastically supported deregulation. Many observers of current banking attitudes have, therefore, drawn the conclusion that large banks favor and small independent banks oppose deregulation. The WIB position on this issue parallels that of the American Bankers Association (ABA).

Another current (and controversial) issue is represented by provisions of the Garn Bill (S. 1720). The IBAA has apparently established a stance of general opposition while the WIB favors an amended version of the Bill. Once again WIB finds itself supportive of the ABA stand.

This letter is being written with the hope that you will realize that the IBAA does not represent the thinking of all independent banks in America. To the great extent that the WIB is in accord with the Community Banking Leaders Council of the ABA, the conclusion may be drawn that the commercial banking industry is, perhaps, much more unified than it is generally supposed.

Sincerely yours,

William C. Wolford
Chairman
WIB Legislative Committee

James D. McMahon
WIB President

[illegible]

National Association of Home Builders

15th and M Streets, N.W., Washington, D.C. 20005
Telex 89-2600 (202) 822-0400

Frederick J. Napolitano
1982 President

June 11, 1982

The Honorable Jake Garn
Chairman
Committee on Banking, Housing, and
Urban Affairs
5300 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the 114,000 members of the National Association of Home Builders, I would like to commend you for your leadership in responding to the serious condition of the nation's thrift institutions. As the foundation of the housing finance system, the soundness of the nation's thrifts is immensely important to the homebuilding industry. Your introduction of the Capital Assistance Act, S. 2351, and The Deposit Insurance Flexibility Act, S. 2352, will refocus Congressional debate on the emergency needs of thrift and other financial institutions. I respectfully request that these comments be included in the hearing record on these two important bills.

The two bills together target assistance carefully and give Federal regulators extra flexibility to tailor the assistance that is provided. Both are desirable measures. We are concerned, however, that once again the emergency assistance needed by thrifts may be sidetracked by consideration of restructuring and expansion of powers of thrifts.

The Federal regulators testifying at the Banking Committee hearings on these bills recommended that the Congress link emergency assistance to an expansion of the powers of thrifts. Their rationale is that non-residential investments will help thrifts avert insolvency. Since thrift institutions were created to serve the housing needs of Americans, any substantial movement of their resources away from residential investment should be scrutinized with unusual care. The question of restructuring thrifts warrants ample investigation. A change of the magnitude possible will likely be controversial. To avoid delaying the emergency assistance that the thrifts need, we urge you to keep the issues of emergency assistance and thrift restructuring separate. Since the House has passed the Net Worth Guarantee Act, H.R. 6267 and the Deposit Insurance Flexibility Act, H.R. 4603, swift Senate action on S. 2531 and S. 2532 will advance the immediate assistance that the thrifts need.

"Housing—A Priority to Preserve the American Dream"

[illegible] expansion of powers should proceed on [illegible] in the financial community may necessitate [illegible] institutions. If there is a link to housing [illegible] sources of funds should be expanded. [illegible] funds could help meet the housing [illegible] Mortgage [illegible] bonds, tax incentives for all institutions [illegible] invest in [illegible] mortgages and privately issued conventional mortgage-backed securities could also help fill any credit gap produced [illegible] diversification of thrift investments. NAHB will be glad to assist [illegible] and the other Members of the Senate Banking Committee in any way [illegible] to explore the range of options available to guarantee a viable [illegible] of mortgage finance.

[illegible] we will vigorously oppose any restructuring [illegible] that allow thrifts and commercial banks to become involved [illegible] in real estate development. The separation of banking from commercial enterprises is fundamental to a competitive free market [illegible] real estate or any line of business. The Federal Home Loan Bank [illegible] expanded savings and loan service corporation activities into real estate development. The sad result has been that some service corporations have engaged in anti-competitive practices. We request [illegible] the Banking Committee condemn these practices and place legislative restrictions on savings and loan service corporations to eliminate the anti-competitive practices that have arisen.

With respect to S. 1531 and S. 1532, we are somewhat concerned by [illegible] that appears to be placed on mergers as the means of solving the financial problems of institutions. Section 203 is [illegible] of that emphasis. Upon a finding of severe financial conditions threatening the stability of institutions generally, it authorizes a [illegible] of cross industry and interstate mergers. While the regulators [illegible] admonished to make a reasonable effort to arrange mergers within industries and within states, the paramount consideration is to protect [illegible] FSLIC insuring fund. This provision gives the regulators virtual carte blanche to arrange mergers at their discretion. While merger authority is necessary, this provision and others like it in S. 1252 [illegible] to the prospect that this emergency authority will be used to restructure the thrift institutions by concentrating financial services [illegible] fewer, larger institutions. The Federal regulators who testified [illegible] the Banking Committee hearings on these bills made clear their intentions of pursuing such a course if they have the powers.

The current policy debate surrounding thrifts goes well beyond [illegible] health of financial institutions. Banks and thrifts were created [illegible] the credit needs of the public. Housing is the major individual [illegible] need of most families. If we evolve to a new financial system, [illegible] should proceed with a conscious determination to produce a system [illegible] ensures competitive mortgage financing.

For further information on our views, please contact Senior Staff [illegible] President, Robert D Bannister at 822-0470.

Sincerely,

Fred Napolitano

Fred Napolitano
President

NATIONAL ASSOCIATION OF TAX ADMINISTRATORS

444 North Capitol Street, N.W.
Washington, D.C. [illegible]
[illegible]

June 21, 1982

Senator Edwin Garn
Chairman
Senate Committee on Banking,
Housing and Urban Affairs
5300 Dirksen Senate Office Building
Washington, D.C. 20515

Dear Senator Garn:

The National Association of Tax Administrators, at its Fiftieth Annual Meeting, on June 3, 1982, adopted a resolution respectfully urging Congress to revise H.R. 6267, the Net Worth Guarantee Act, and S. 2531, the Capital Assistance Act, by eliminating provisions which defer state and local taxes on depositories or exempt them from such taxes. The resolution makes this request in order to avoid interference with state taxing authority and the state revenue loss that would result. A copy of the resolution is enclosed. NATA would be pleased to submit further explanation or comments at your request.

The National Association of Tax Administrators is an organization of tax agencies of the governments of the fifty states. Your consideration of the states' concerns with respect to this legislation is greatly appreciated.

Sincerely,

Leon Rothenberg
Executive Secretary

Enclosure

RESOLUTION UNANIMOUSLY ADOPTED AT THE [illegible] ANNUAL MEETING OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, HELD IN NEW ORLEANS, LOUISIANA, MAY [illegible] TO JUNE 4, [illegible]

[illegible]

WHEREAS, the House of Representatives has passed H.R. [illegible]267, the Net Worth Guarantee Act, and the Senate Banking Committee has concluded hearings on S. [illegible], the Capital Assistance Act, and

WHEREAS, the Net Worth Guarantee Act would waive state and local taxes on depositories for which net worth guarantees are issued and the Capital Assistance Act would exempt such depositories from state and local taxes, and

WHEREAS, these provisions would result in a loss of state revenue, interfere with state taxing authority, and subordinate the federal and state tax systems for federal purposes, and

WHEREAS, while recognizing the merit of this legislation to aid troubled financial depositories, the states are deeply concerned over federal measures which interfere with state taxing authority and cause state revenue losses, particularly at a time when states have a serious need for additional revenue, now, therefore, be it

Resolved, that the National Association of Tax Administrators urge Congress to revise the legislation in question in order to eliminate interference with state taxing authority and avoid the revenue losses that would result.

National Conference of State Legislatures

Office of State Federal Relations

444 North Capitol Street, N.W.
2nd Floor
Washington, D.C. 20001
202/624-5400

President
Ross O. Doyen, President of The Kansas Senate

Executive Director
Earl S. Mackey

[illegible] 82

The Honorable Jake Garn, Chairman
Committee on Banking, Housing &
Urban Affairs
5300 Dirksen Senate Office Building
Washington DC 20510

Dear Senator Garn:

On behalf of the National Conference of State Legislatures, I wish to express opposition to certain provisions of S. 2531, the Capital Assistance Act of 1982 and S. 2532, the Regulator' Bill Although we support the necessity of both of these measures and federal action to address the problems of ailing financial institutions, several provisions of these bills would damage states' ability to regulate financial institutions within their borders and would erode the tax base of states and localities.

The provision of most concern within S. 2531 would exempt financial institutions receiving federal assistance from all state and local taxes based on deposits. This provision, preempting any state and local franchise taxes, disregards the fact that: (1) no other federal assistance program requires foregoing state and local taxation (2) state and local taxation appears not to materially affect the profitability of these institutions, in judging whether federal taxes are imposed, and (4) other groups such as small businesses, auto dealers, airlines, and other industries similarly troubled would soon approach Congress for exemptions. On these grounds, NCSL would urge the Committee to eliminate this provision from the legislation.

As you may know, NCSL has supported passage of H.R. 4603 and feel that some assistance to troubled institutions is necessary. Our concerns with S. 2532, however center around the need for state regulatory authority and state laws to be considered and preserved to the maximum extent possible under the legislation. In particular NCSL would support amendments to S. 2532 which would subject financial institutions acquired under the bill to the state laws where the institution is currently located give preference to intrastate acquisitions and provide for the participation of state regulatory bodies in acquisition decisions. We feel these changes are necessary to maintain a balance between acquired institutions and institutions attempting to maintain their viability. At a time when all institutions are facing difficulties, it does not seem a wise federal policy to promote a competitive advantage on behalf of institutions previously close to failure over institutions seeking to avoid the need for federal assistance.

STATE OF NEW MEXICO
OFFICE OF THE GOVERNOR
SANTA FE
87503

BRUCE KING
GOVERNOR

June 10, 1982

The Honorable Jake Garn, Member
Senate Committee on Banking,
Housing and Urban Affairs
5300 Dirksen Senate Office Building
Washington, D.C. 20510

Subject: HR 6267 and S. 2531

Dear Senator Garn:

It has come to my attention that your committee may soon be considering H.R. 6267, the Net Worth Guarantee Act. This bill is similar to S. 2531, the Capital Assistance Act of 1982, which has already been heard by your committee.

Both of these bills are aimed at temporarily bolstering the net worth of troubled state and federally insured depository institutions (banks, saving institutions and credit unions). Among other things, both bills use relief from state and local taxes as a means for providing financial assistance to eligible depositories. H.R. 6267 would defer state and local taxes based on deposits or interest paid on deposits. S. 2531 would exempt such institutions from state and local taxes of this type.

I would like to express my opposition to both of these measures since they infringe upon the states' legitimate right to tax businesses operating within their borders. While the concept of a deferral of state and local taxes contained in the House bill is preferable to the outright exemption of taxes contained in the Senate bill, both bills represent a disturbing example of federal legislation granting tax relief at the expense of state and local governments. This type of legislation arbitrarily erodes our tax base and undermines our ability to rationally plan for and implement our own financial policies. Thus, it is inconsistent with the goals of the new federalism.

As you continue your deliberations on this matter, I would request that you reconsider the provisions relating to state and local taxes. I would also request your assistance in assuring that input from state and local government representatives is solicited and considered should similar proposals come before the Committee.

Sincerely,

Bruce King

BRUCE KING
Governor

ANSWERS TO SUBSEQUENT QUESTIONS FROM CHAIRMAN GARN TO FEDERAL RESERVE BOARD

Question 1. S. 2531 authorizes the FDIC and FSLIC to provide capital assistance for any insured institution that meets the eligibility criteria set forth in the bill Therefore, if a commercial bank meets the criteria, it is eligible for assistance.

(a) What are your views on including commercial banks if they meet the eligibility criteria? Do you believe that is appropriate, or should the legislation be limited to only thrift institutions?

Answer: As a practical matter, I believe that there is a much less compelling case for including commercial banks within the scope of institutions eligible to receive capital assistance. Even if they were eligible, I would expect that there would not be many cases in which banks would justifiably make use of the new facilities, and there is no general problem in the industry comparable to that of thrifts.

I can recognize, as a matter of symmetry and equity, a case can be made that legislation designed to provide support for the financial system should provide similar treatment of all depository institutions suffering from the same problems which triggered the congressional decision to provide relief through a capital assistance facility. If this line of reasoning may lead the Congress to conclude that discretionary authority should be granted to include commercial banks, but, in that event, assistance in my view should be confined to only those institutions having asset structures closely comparable to thrifts--that is principally composed of mortgage loans.

(b) The House bill currently applies more lenient standards for commercial banks by qualifying them for assistance at higher net worth levels than the thrifts. Do you support or oppose that provision? Explain.

<u>Question 2.</u> Chairman Pratt opposes including nonfederally insured institutions within the scope of any capital assistance legislation.

(a) What is your agency's position on including state insured institutions?

<u>Answer</u>: The principle expressed by Chairman Pratt seems to be appropriate. State insured institutions have deliberately chosen not to operate under the federal scheme, which provides the benefits of federal deposit insurance and access to FHLBB credit, but imposes the burdens of a supervisory framework including regulation of interest rates and contributions to the insurance funds. Thus, there is no direct federal financial or supervisory responsibility for these institutions.

As a practical matter, in some cases failure of a non-insured institution might be damaging to the stability of insured institutions because of confusion or uncertainty in the public mind. For that reason, I would not oppose limited discretionary authority to the federal regulators to permit state insured institutions to participate in the capital assistance program. I believe that as a condition of eligibility such institutions should be required to secure federal deposit insurance, either immediately or after a grace period, and thereby become subject to all relevant federal regulations. The state insuring agencies or corporations should be required to participate equitably in the assistance. Preferably, arrangements should be instituted to fold state insurance funds into the federal system. The current situation points up the weaknesses and inequities in the existing situation at a time of distress.

6. Describe the regulatory and supervisory complications, if any, that would be entailed by including state insured institutions within the capital assistance bill.

Answer: If such assistance is provided, it is essential that there be close cooperation between Federal and State authorities both in order to obtain the information necessary to provide assistance and to assure that the assisted institution will operate in a manner consistent with its return to profitability under more normal market conditions. Conditioning assistance on qualifying, one way or other, for Federal insurance would also remove any barriers to a Federal supervisory role which would be an essential part of capital assistance.

<u>Question 3</u>. Chairman Isaac recommends deleting the provision in <u>the capital</u> assistance bill that would limit capital assistance to 100% of losses because he believes it is unduly restrictive and inhibits flexibility. What is your view on that recommendation?

<u>Answer</u>: I would support Chairman Isaac's recommendation that additional flexibility be provided to allow capital assistance of more than 100 percent of losses for the "immediately preceding period." In particular, I would favor legislation that would permit, in carefully circumscribed instances, larger amounts of capital infusion if it would ultimately result in less cost to the insurance funds. For example, there may be specific situations in which it is desirable to raise the capital level of an institution with low capital to a specific level, such as 2 percent, and maintain it at that level for a period. Moreover, the erosion of an institution's relative capital position could be affected by factors other than operating losses and this also suggests a need for greater flexibility. Once an institution becomes eligible for assistance, it seems appropriate to allow the supervisory agency a degree of discretion in determining the appropriate amount of assistance that the institution needs.

<u>Question 6.</u> The House passed Capital Assistance Bill requires the [illegible] to consult with the State supervisory of the State in which any state chartered institution is located with respect to the eligibility of such institutions. What are your views on that provision?

<u>Answer:</u> I would support a requirement that the state supervisor be consulted whenever a state chartered institution is seeking capital assistance. Close coordination is common today between state and federal regulators. Such procedures recognize the role that States play in maintaining a sound financial system. In contrast, lack of coordination of state and federal supervisory efforts would lead to unnecessary duplication of efforts or, possibly, to the agencies working at cross purposes. Requiring the agencies to draw on the expertise of the State supervisors in deciding whether to provide capital assistance would be a positive element in the process.

tion 5. What is your view on adding a provision of S. 2531 h would require the FHLBB and the FDIC to promulgate regula- s implementing the provisions of the Capital Assistance Act?

Answer: I believe it would be desirable to provide agencies with rulemaking authority. However, in many instances, provisions of the bill seem to set forth a sufficient structure mplement this program. Accordingly, implementing regulations not be necessary in all areas, and I do not favor requiring agencies to develop regulations.

Question 6. Would the Fed approve the acquisition by a bank holding company of a thrift which was not on the verge of imminent collapse, but which would not be considered "healthy under regulatory definitions of thrift net worth in effect two years ago?

(a) Do you think it would be beneficial to have a different and more liberal standard for voluntary mergers or acquisitions--which will not cost the insurance funds any money--as opposed to the standard for financial aid under the Regulators' Bill?

(b) Should there be a different standard for voluntary, as opposed to forced acquisitions?

Answer: Questions 6(a) and 6(b) appear to be closely related, and I will answer them together. As I advised Chairman Isaac in my letter setting forth the Federal Reserve's policy regarding bank holding company acquisitions of thrifts, the Board is prepared to consider proposals to acquire a financially troubled thrift institution in instances where the possibility of such an acquisition would significantly reduce the costs and risks involved and otherwise be consistent with the public interest. In determining whether an institution is in financial distress, the Federal Reserve has placed considerable reliance on the views of the institution's primary regulator. Thus, the Board is focusing the remedy of inter-industry acquisitions for the problems of the thrift industry on those institutions that are in serious need of assistance. However, this approach would not exclude "voluntary" mergers of the type you describe, and indeed the recent "Scioto Case" did not involve federal insurance funds. The standard is essentially one of net benefit to the public, which in our present approach, suggests that the acquired institution be seriously financially troubled, in our judgment and that of its supervisor, but not necessarily on the verge of "imminent collapse."

The Board's belief that it should only process applications to acquire financially troubled thrifts can be traced to its 1977 decision in the D.H. Baldwin case. In that instance the Board, in applying the balancing of public benefits and adverse effects required by section 4(c)(8) of the Bank Holding Company Act, denied a bank holding company proposal to acquire a thrift on the ground that such acquisitions could produce regulatory conflict, reduce procompetitive institutional rivalry, and undermine geographic limitations that apply to banking organizations. There is reason to believe that these adverse effects may have diminished somewhat in the last five years, partly as a result of broader thrift powers. However, the Board has taken the position at this time that the potential adverse effects of such acquisitions are clearly outweighed only in the situation of public benefits flowing from dealing with financially distressed institutions. This conclusion implies that a financially distressed criterion should be retained at present for voluntary mergers.

Question 7. In the Fed's recent approval of the acquisition of Scioto Savings Association by Interstate Financial Corporation, a bank holding company, the Fed imposed anti-branching requirements on the thrift.

(a) Do such anti-branching restrictions place the affected savings and loan at a competitive disadvantage compared to other thrifts?

Answer: In some proposals involving the acquisition of a thrift institution by a bank holding company a limitation of branching may well be appropriate if the Board is to fulfill its responsibility to balance public benefits and adverse effects under the Bank Holding Company Act. In the Scioto case, the thrift institution was not federally insured and proposed to pay interest rates greater than those that would be allowed for either a federally insured bank or thrift. Under such circumstances it would not be appropriate to allow the state insured thrift institution paying unregulated rates to in effect trade on the name of its newly affiliated bank or, in these circumstances, to branch in a manner that a banking institution could not. This limitation thus insures that the thrift institution would not have an undue advantage over banking organizations located in Ohio. In other cases, where a federally insured thrift is being acquired, the Board would have to consider in its overall evaluation of the application, whether intrastate branching or interstate branching would provide the institution with an unfair advantage, taking account of relevant state law.

(b) Do such restrictions, applied generally, remove an important incentive for bank holding companies to purchase thrifts, thereby making it more difficult to find willing merger partners?

Answer: Bank holding companies have an interest in acquiring thrift institutions in order to penetrate attractive new markets. This was demonstrated in the Scioto case where the restrictions on branching to assist in avoiding a competitive imbalance were not an impediment to consummation of the acquisition of a thrift by a bank holding company.

The factors that enter into the calculations of bank holding company decisions to bid on stressed thrift institutions are complex, and broader branching powers would, no doubt, constitute an additional positive factor in these calculations. Nevertheless, I would not regard branching limitations as a major impediment to bidding by bank holding companies for thrift institutions. In the light of this assessment, and until Congress changes the laws regulating these matters, fairness requires the Board to take into account the competitive impact of branching powers in carrying out its responsibilities for weighing public benefits against adverse factors in applying section 4(c)(8) of the Bank Holding Company Act. More generally, the Board has thought it inappropriate for a bank to exercise in an important way powers through a thrift acquisition (such as real estate development) not permitted bank holding companies generally.

[illegible]

Federal Home Loan Bank Board

__Questions from Senator [illegible] on May 26 Hearings__

__Question 1__

S. 2531 requires institutions receiving assistance to agree to comply with all terms and conditions established by the Corporation, including restrictions as to merger or management. The bill that was passed by the House specifically prohibits conditioning assistance upon such a resolution.

(a) How important is such a provision and would you continue to support this bill if it was amended to preclude such conditioning? Explain.

(b) What is your view on including a standard that is similar to the provision that was added to the House bill which allows the corporations to require such a resolution only if the institution receiving assistance has net worth of less than 1%?

__Answer 1__

(a) As a practical matter the Bank Board generally would not seek as a routine prerequisite to capital assistance a merger resolution or execution of a master agreement permitting the FSLIC to merge the assisted institutions at its discretion.

See attached letter from Chairman Pratt to William O'Connell dated June 14, 1982.

(b) The Bank Board is comfortable with either a time or net worth standard or both.

QUESTION 2

S. 2531 authorizes the FDIC and FSLIC to provide capital assistance for any insured institution that meets the eligibility criteria set forth in the bill. Therefore, if a commercial bank meets the criteria, it is eligible for assistance.

(a) What are your views on including commercial banks if they meet the eligibility criteria? Do you believe that is appropriate, or should the legislation be limited to only thrift institutions?

(b) The House bill currently applies more lenient standards for commercial banks by qualifying them for assistance at higher net worth levels than the thrifts. Do you support or oppose that provision? Explain.

ANSWER 2

(a) The Bank Board would not withdraw our support from the legislation on these grounds, inasmuch as testimony by Comptroller Conover indicated that the number of commercial banks which would likely be eligible for this assistance is miniscule. Moreover, because the FSLIC insurance fund would not be affected by Congress' decision on this matter, we believe that the question of the appropriateness and equity of such aid for commercial banks is one which should ultimately be left to Congress, based on the opinions of the primary regulators of those institutions.

(b) The Bank Board believes that, if capital assistance is extended to commercial banks, the criterion for eligibility for commercial banks should be similar to that for thrifts, but should

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take into account the different capital structures, availability and regulations that apply to commercial banks and not to thrifts.

QUESTION:

Chairman Isaac recommends deleting the provision in the mutual assistance bill that would limit capital assistance to 100% of losses because he believes it is unduly restrictive and prohibits flexibility. What is your view on that recommendation?

ANSWER:

The Bank Board continues to support the current provision limiting the amount of reimbursement to 100% of losses for the immediately preceding period. As I testified on May 26, the Bank Board's primary concern with any federal intervention to assist thrifts is that it should be structured in a way that is market disciplined and neutral in impact, preserving the strong institutions while permitting the weakest members of the industry to go out of existence. The primary reasons for the use in S. 2531 of partial loss coverage are to maintain pressure on institutions to take all possible measures to cut costs and to remove any incentive to incur losses artificially because of the existence of the subsidy. The partial loss assistance formula in S. 2531 would lessen the incentives for losses and would address the concern that institutions with healthy and substantial net worth would be at a disadvantage relative to ailing competitors backed by subsidies issued under S. 2531.

Given the Bank Board's narrow view of the appropriate purposes and scope of federal intervention for thrifts, we do not

believe that any additional flexibility for administration of capital assistance under S. 2531 is necessary or appropriate. The argument for increased flexibility under this program is also unpersuasive because S. 2531 would not hamper, or limit in any way, the Bank Board's ability to provide greater amounts of assistance under its other default prevention procedures, such as the "Phoenix" arrangements, whereby a weakened institution receives net worth support through an infusion of cash or cash equivalents in consideration for the institution's issuance of Income Capital Certificates to FSLIC.

QUESTION 4

The House passed Capital Assistance Bill requires the insurance corporations to consult with the State supervisor of the State in which any state chartered institution is located with respect to the eligibility of such institutions. What are your views on that provision?

ANSWER 4

The existing procedure for communicating the efforts of the Federal Savings and Loan Insurance Corporation (FSLIC) in assisting a troubled state chartered institution calls for close interaction with the State savings and loan supervisor. The Supervisory Agent of the Federal Home Loan Bank in each district works cooperatively with the State supervisor to outline alternative solutions for troubled institutions. The inclusion in the House Bill of this requirement does not appear unreasonable, nor does it appear to contradict the efforts of the FSLIC or the FHLBB.

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Question :

S. 2332 requires the FDIC, in making decisions about 'extraordinary acquisitions' of insured banks (Sec. 108), to consult the state bank supervisor of the State in which the bank which is closed or in danger of closing is chartered. The provision gives state supervisors at least 48 hours to object to the determination of FDIC, and if there is an objection, FDIC can proceed only by a unanimous vote of the Board.

What are your views on including a similar provision within Section 103 of S. 2332, which provides for emergency thrift acquisitions?

Answer :

Section 110 of S. 2333 requires consultation with state authorities when the potential acquirer of a large institution is either an in-state depository institution established by an out-of-state bank or holding company, or is an out-of-state bank or holding company.

Clearly, regulators of state-chartered savings and loans have a strong interest in any transaction which, under Section 203 of S. 2333, might change the competitive environment for state-chartered thrifts or result in the acquisition of a state-chartered thrift by an out-of-state thrift or non-thrift acquirer such as a bank, bank holding company or other non-thrift entity. The Bank Board believes that an opportunity for comment by state regulators in such situations, similar to the one in S. 2332, strikes the proper balance between the state's interests

and those of the Bank Board in being able to respond swiftly and effectively in a true emergency.

QUESTION 6

What is your view on adding a provision to S. 2531 which would require the FHLBB and the FDIC to promulgate regulations implementing the provisions of the Capital Assistance Act?

ANSWER 6

A provision requiring the Bank Board to write regulations to implement the assistance program could unnecessarily limit the Bank Board's flexibility to respond quickly and efficiently because of the large number of FSLIC-insured institutions which would theoretically be eligible for assistance under this bill immediately. However, we anticipate that the program would be run in a fairly routine manner without daily monitoring of the conditions of the various institutions participating. Thus, as S. 2531 is now drafted, I do not anticipate that the Bank Board would need to write extensive regulations to implement the program. In fact, major regulations would likely be needed only if the Bank Board decided to impose extensive and complex conditions as a prerequisite to assistance or intended to alter the partial loss coverage formula which is the minimum of aid to be provided under the bill. Accordingly, while the Board would not view a regulation-writing requirement as unduly burdensome, we would prefer retaining discretion.

Incidentally, such a requirement would seem to be redundant because Section 402 of the National Housing Act authorizes the

Federal Home Loan Bank Board to direct the operation of the FSLIC under such rules and regulations as "it may prescribe for carrying out the purposes of this subchapter," which subchapter includes Section 406 of the National Housing Act, the section amended by S. 2531.

QUESTION 7

What is the relationship between the Regulators' Bill and the Capital Assistance Bill, if any?

(a) For example, could an insured depository institution be sick enough to qualify for capital assistance because its net worth dipped below the three percent level and at the same time be too "healthy" for assistance contemplated under the Regulators' Bill, such as supervisory mergers or acquisitions?

(b) Would an institution — say a savings and loan -- with a net worth of four percent be eligible now under the Regulators' Bill before us for capital assistance or merger approval if the institution had a history of declining net worth, clear trend of losses, and bleak prospects for reversing this process?

(c) Would such an institution, even though not considered to be immediately threatened, or "failing," be a candidate for the FSLIC assistance envisioned under the Regulators' Bill?

ANSWER 7

(a) The assistance contemplated under the Regulators' Bill is envisioned as a default prevention tool that would be utilized on a case-by-case basis to deal with actual or developing problem cases on an early basis. Specifically, FSLIC's ability to provide

financial assistance to an institution, and its authority to permit inter-industry mergers, would depend on a finding that a particular institution's "stability" is threatened when severe financial conditions exist threatening the stability of a "significant number of insured institutions or of insured institutions possessing significant financial resources" and that the aid given would lessen the risk to the FSLIC. Under this test, the FSLIC could aid a large S&L with marginally healthy net worth levels if the requisite economic disruption existed and early action was warranted to protect the fund. Such a finding would not be justified to aid institutions with low net worth levels, but with a trend of declining losses and good prospects for profitability in the near term. Thus, we believe it is very likely that some institutions would be eligible for help under the Capital Assistance Bill by virtue of low net worth levels, but would not qualify under the Regulators' Bill because their condition was not an early warning of impending insolvency.

(b) and (c) Given the standard described above, under current economic circumstances, FSLIC could legally provide the institutions described with financial help or permit it to engage in an extraordinary merger, if assistance would reduce the risk to the FSLIC. It is very unlikely, however, that the institution would be a practical candidate for help under the extraordinary powers sought, which, to reiterate, are seen as tools for use with regard to associations that are in dire straits rather than those that may have an indeterminate period to insolvency.

QUESTION 8

Would it be fair to say that many of these mergers occurred because there was no alternative, or no better alternative, to keeping the institutions viable?

ANSWER 8

The selection of a merger solution in resolving the problems of a troubled institution is determined after considerable attention is given to alternatives for simultaneously protecting the safety of deposits, the viability of the insurance fund, and the institution's future role in the community. We are constantly updating our guidelines and procedures for resolving market conditions confronting a particular institution. In each situation, the priority of our alternatives begins with management advice to assist institutions in finding ways to cut costs, restructure their portfolios, and identify ways to raise new capital. When self-help measures are insufficient and/or if new capital cannot be raised, the FHLBB uses mergers as another tool with which to solve the current problems.

See attached memos dated October 15, 1981, February 2, 1982 and May 1982 from H. Brent Beesley, D. James Croft and Thomas P. Vartanian to Supervisory Agents, OES staff, FSLIC staff and OGC staff.

QUESTION 9

Could you please state the position of your agency on the amendment which was added to the Regulators' Bill in the House designed to subject any savings and loan acquired by a bank holding

company under the Regulators' Bill to the bank branching laws of that jurisdiction?

(a) Does this provision make it more difficult to save "failing" thrifts?

(b) Is this provision counter-productive in that it would extend the restrictive principles of current branching law for national banks to savings and loan associations for the first time? Is this a desirable precedent?

ANSWER 9

(a) In our view, such a provision moves regulation of and economic and geographic competition among financial institutions in the wrong direction. It would also make it extremely difficult for the FSLIC to continue to find merger partners for thrifts in financial difficulties. At present, the existence of branches of a failing institution throughout markets in the state may provide a great incentive to either an in-state or an out-of-state acquirer desiring to expand in a certain geographic area. Under current law, existing savings and loan institutions of both federal and state charter have very wide latitude in the geographic location of their branches. There are no federal statutory restrictions on the placement of branches, and the Board currently permits federal S&Ls to branch anywhere within their home states as long as state law permits branching by state-chartered financial institutions. 12 C.F.R. § 556.5(a)(2).

Additionally, the Board permits certain mergers and reorganizations resulting in the establishment of a branch office in a state

other than the state in which an association's home office is located if: (1) the proposed acquisition is effected pursuant to a default prevention procedure for a FSLIC-insured institution, (2) the insurance liability to the FSLIC would be reduced as a result of the proposed transaction, and (3) the liability to FSLIC is substantially less than the liability that would result from an otherwise equally desirable acquisition alternative, if any, that would not result in interstate branch operations. The Board also permits an association that has established a branch office in a state other than the state in which its home office is located, pursuant to a default prevention action, to establish additional branch offices in that state with Board approval. The Board's policy, regarding supervisory mergers and branches established in connection with such mergers, was developed to ensure that the FSLIC was given the flexibility necessary to structure an acquisition in a manner resulting in the greatest reduction of the insurance liability or risk to the FSLIC, thus maximizing the fund's utility. Imposing state branch banking laws on thrifts acquired by bank holding companies under the Regulators' Bill would make a thrift a much less desirable acquisition partner for a BHC because of the possibility that divestiture would be required to comply with state bank branching laws. It is likely in many cases that the chief incentive for the BHC to acquire the thrift would be removed if the divestiture affected the BHC's opportunity to enter a new market within the state where the home office of the thrift was located.

(b) In view of the problems outlined above, the Board would strongly oppose the adoption of such a restriction on savings and loans branching activity. Such a restriction, in our view, would be especially inappropriate given the current revolutionary climate in the financial services marketplace. The restrictions on branching by national banks were developed more than four decades ago, in an era of rigid product and geographic segregation. Such strictures are of questionable wisdom in an age of electronic banking and the rapid growth of non-regulated financial entities which, as a practical matter, are able to provide banking services on a nation-wide basis. Therefore, the Board believes it would be especially untimely for Congress to attempt to impose McFadden-like strictures on thrifts acquired by bank holding companies under the Regulators' Bill without a careful study assessing the utility and continued justification for the application of the McFadden Act to national banks in the first instance. Imposing bank-like branching restrictions on thrifts at the current time would also aggravate the competitive inequity existing between thrifts and non-regulated entities able to operate without artificial geographic barriers to competition, such as the money market funds.

Additional [illegible]

[illegible]

a) [illegible]

b) [illegible]

c) [illegible]

ANSWER.

These first questions are really a means of identifying whether FSLIC's existing powers are adequate to deal with the current problems of the thrift industry and what steps may be necessary to enhance FSLIC's efficiency. The Bank Board supports specific changes to current law which would affect FSLIC's authority to act as conservator or receiver for state- and federally-chartered associations insured by FSLIC. These revisions are incorporated in the "Thrift Institutions Restructuring Act" (S. [illegible]), the "Financial Institutions Restructuring and Services Act of 1981" (S. 1720) and the "Regulators' Bill" (S. 2532). These changes would recognize the fact that FSLIC's responsibility as insurer and its exposure in cases of default are substantially the same whether the institution is federally- or state-chartered. In fact, it has proven to be quite costly for the FSLIC to be powerless to act in certain cases involving the appointment of a state receiver other than the FSLIC. Accordingly, with the proposed changes, FSLIC would have conservatorship and receivership powers over State-chartered insured institutions

approximately equal to those which it now has with respect to Federal associations. While the FSLIC still could accept an appointment as receiver or conservator from a State authority, and operate according to its regulation, the Bank Board would be able to appoint the FSLIC as sole conservator or receiver of a State-chartered insured institution, superseding and preempting any state appointment, upon a determination by the Bank Board that the institution was in an unsafe or unsound condition to transact business, had substantially dissipated its assets, or had assets less than its obligations. Under current law, such preemptive power exists only where an institution actually has been closed by or under state law, or a State receiver or other custodian has been appointed for at least 15 days, where grounds exist identical to those required to appoint a receiver or conservator for a Federal association, and an account-holder has been unable to obtain a withdrawal of his account in whole or in part.

(a) The power of the Bank Board and the FSLIC to close an association or to exercise its rights absent closure derives primarily from the two statutory schemes governing conservatorships and receiverships of federal associations and FSLIC-insured non-federal associations. In both cases, the termination of the rights and powers of existing management or officers is incidental to the plenary authority to manage the association conferred on a Bank Board-appointed conservator or receiver.

As to a federal association, any of the following are grounds for the Bank Board's appointing a conservator or receiver:

(1) the association's assets are less than its obligations to others, including its members;

(2) its assets or earnings are substantially dissipated due to violation(s) of law, rules, or regulations or to unsafe or unsound practice(s);

(3) it is in an unsafe or unsound condition to transact business;

(4) it willfully violates a "cease-and-desist order which has become final," as defined in section 5(d) of the Home Owners' Loan Act;

(5) it conceals its records or assets or refuses to submit its records or affairs for inspection to an examiner or lawful agent of the Board; or

(6) the association's Bank membership or insurance by FSLIC is terminated.

12 U.S.C. § 1464(d)(6)(A), (B); 12 C.F.R. §§ 547.1, 547.2. In all cases where a receiver is appointed for a federal association, the Bank Board must appoint the FSLIC.

Pursuant to statute and Board regulations, a conservator or receiver appointed under Section 1464 succeeds to all rights and powers of the association, its officers and directors. In addition, no member, officer or director of the association may thereafter exercise any power or act in any connection with the association's assets or property. 12 U.S.C. § 1464(d)(6)(D); 12 C.F.R. §§ 547.7, 547.8, 548.2, 549.3.

In addition to the power of appointment set out in Section 1464(d)(6)(A), Section 406(b) of the National Housing Act (12 U.S.C. § 1729(b)) also provides for mandatory appointment of FSLIC as conservator or receiver for federal associations in default. 1/ Under this statute and implementing regulations, FSLIC also has the power to exercise all rights and powers of the association, to close an association, or to merge it with an existing or newly organized federal S&L, or to proceed to liquidation. 12 C.F.R. §§ 548.2, 549.3.

As to FSLIC-insured state-chartered institutions, the FSLIC may act as legal custodian and eventually merge or sell the assets of the institution, or liquidate it, pursuant to 12 U.S.C. § 1729(c)(1)-(2). The statute provides two alternative conditions for appointment of FSLIC as such a custodian. First, FSLIC <u>must</u> act as custodian if the institution is in default and the relevant court or public authority requests FSLIC's appointment.

Second, the Board may appoint FSLIC as conservator or receiver if the following three conditions are met:

1. either (a) a legal custodian has been appointed for an insured institution and that appointment has been outstanding

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1/ Defined by statute to mean a judicial or other official determination pursuant to which a conservator, receiver or other legal custodian is appointed for an institution for the purpose of liquidation. 12 U.S.C. § 1724(d).

for at least fifteen consecutive days, or (b) an insured institution has been closed by or under the laws of the State; <u>and</u>

2. one or more of the grounds specified in 12 U.S.C. § 1464(d)(6)(A) existed with respect to the institution at the time the legal custodian was appointed, at the time the institution was closed, or while the institution remains closed; <u>and</u>

3. one or more of the holders of withdrawable accounts in such institution is unable to obtain a withdrawal of his account, in whole or in part.

Section 1729(c)(2) and Board regulation confer on FSLIC all the rights and powers of the association and its directors and officers, and full discretion to dispose of the institution's assets in the manner it deems in the best interests of the institution, its savers and the fund.

As discussed above, the statutes authorizing a FSLIC receivership result in a <u>transfer</u> of all the rights and powers of existing management to FSLIC as receiver. Apart from the failing institution context, a separate statutory scheme expressly authorizes removal of officers and directors for wrongdoing, under certain circumstances. Generally, FSLIC and the Bank Board can remove

officers and directors from office on a showing that the official concerned has: (a) violated law or engaged in an unsafe practice; and (b) the association has suffered financial loss; and (c) the violation or practice involved personal dishonesty by the official or a willful disregard for the institution's soundness. In certain cases, an officer or director may also be removed if convicted of a felony involving breach of trust.

The relevant statutory provisions governing removal of officers and directors are found in 12 U.S.C. § 1464(d)(4)-(5) (federal associations) and 12 U.S.C. § 1730(g)-(h) (FSLIC-insured institutions).

(b) Independent of the thrift assistance plan of S. 2531, the FSLIC's ability to provide net worth or other assistance to distressed institutions is governed by Section 406(f) of the National Housing Act, 12 U.S.C. § 1729(f). Under this statute, the FSLIC is authorized to make a contribution to, make loans to, or purchase the assets of, an insured institution which is in default or in danger of default, but is restricted by the general requirement that any contribution or guarantee "may be no more than reasonably necessary to save the cost of liquidating the institution."

To date, as a practical matter, the Bank Board has found that FSLIC's Income Capital Certificate (ICC) program has been an efficient default-prevention tool to provide capital assistance

under Section 406(f) to institutions in severe financial condition. However, this program, limited as it is because of current statutory language and the institutions with which it is dealing, has not been considered by the Board as being susceptible to expansion to provide industry-wide assistance. The program contemplates that in certain appropriate cases, an S&L will issue ICCs to the FSLIC in exchange for cash, five-year promissory notes of the FSLIC, or a combination of both. In order to protect the FSLIC's investment and discourage institutions from petitioning the Board for admittance into this limited default-prevention program, ICCs have been issued in accordance with a master agreement which provides for, inter alia, limitations on transactions with affiliates, delivery of specified financial information, and compliance with the terms of the purchase agreement under which the ICCs were purchased. This purchase agreement in turn sets forth an additional set of covenants, including substantial covenants with respect to the future operation of the association.

Associations issuing ICCs are required to make repayment only if they have net income, with payments being limited to the specified percentages of such net income, which varies according to the level of net worth to assets met by the association.

The ICC program is an extremely efficient use of the insurance fund's resources for net worth support in appropriate circumstances, because it can be structured to result in immediate net worth gains under generally accepted accounting principles for the issuing

institutions, while not necessarily resulting in an immediate cash outlay by the fund. Moreover, under current economic conditions, the cost of a merger supplemented by ICCs is estimated to run less than 20% of the cost of liquidation. ICCs have been issued mostly in conjunction with certain mergers known popularly as "Phoenix Plan" mergers, where there have been several weak associations in an area for which there are no other affordable alternatives.

In addition to the steps outlined above, the Board may provide limited assistance to the industry by amending its standards for determining compliance with the regulatory net worth requirement.

(c) As a matter of policy, the FSLIC monitors distressed associations and begins to encourage them to seek means of addressing capital problems when they are projected to reach insolvency within 24 months. FSLIC's first preference in such circumstances is for new capital, such as by conversion, with mergers, and liquidation being less preferred alternatives.

Because an institution which has 6 months or less to insolvency is frequently in violation of the net worth requirements of 12 C.F.R. § 563.13, FSLIC has also made it a policy to attempt to persuade the institution to provide FSLIC with a

merger resolution, at the latest, by the projected date of 6 months to insolvency. If an institution can neither help itself by finding some means of voluntary capital infusion, and refuses to provide the FSLIC with a merger resolution, and continues in violation of the net worth requirements, the Bank Board and FSLIC have no recourse but to bring a cease-and-desist procedure against the institution pursuant to the provisions of the Home Owners Loan Act or the National Housing Act. Both acts empower the Bank Board, with regard to federal associations, and the FSLIC, with regard to non-federally chartered insured institutions, to issue a notice of charges to cease-and-desist if it is found that an institution is in violation of any law or regulation, or is engaging in an unsafe or unsound practice. Since the prosecution of a cease-and-desist order to its final conclusion may take a number of months, the statutes also provide for the immediate issuance of a temporary cease-and-desist order when the Board or FSLIC finds that the violation of law or unsafe practice is likely to cause insolvency, or to seriously prejudice the interests of savings account holders prior to the completion of the proceedings. Such temporary orders may require the association to cease-and-desist from the violation, and "to take affirmative action to prevent such insolvency" pending completion of the proceedings. This type of order becomes effective upon service on an association, unless set aside by a federal court.

In accord with these statutory provisions, the Board or FSLIC will institute cease-and-desist proceedings and issue a temporary cease-and-desist order against an institution in violation of its regulatory net worth requirement requiring that the institution bring itself into compliance with the regulatory net worth requirement as the affirmative remedy stipulated in the statute. In many cases, the service of such a temporary order on an association will result in negotiations leading to the association's decision to comply with FSLIC's request for a merger resolution.

QUESTION 2

GAO would audit assistance program semi-annually. Does GAO now audit under statutory mandate? What statute? Specifically to do what?

ANSWER 2

The FSLIC, as a wholly-owned government corporation, 31 U.S.C. § 846, is subject to GAO audit. 31 U.S.C. §§ 850-51. Section 850 provides in pertinent part as follows:

> The financial transactions of wholly owned Government corporations shall be audited by the General Accounting Office in accordance with the principles and procedures applicable to commercial corporate transactions and under such rules and regulations as may be prescribed by the Comptroller General of the United States . . . . The representatives of the General Accounting Office shall have access to all books accounts financial records reports files and all other papers, things or property belonging to or in use by the respective corporations and necessary to facilitate the audit, and they shall be afforded full facilities for verifying transactions with the balances or securities held by depositories fiscal agents and custodians. . . . The audit of the Federal Savings and Loan Insurance Corporation shall be conducted on a calendar year basis.

Section 851 provides in pertinent part:

> A report of each audit conducted under section 850 of this title shall be made by the Comptroller General to the Congress . . . . The report shall set forth the scope of the audit and shall include a statement (showing intercorporate relations) of assets and liabilities, capital and surplus or deficit; a statement of sources and application of funds and such comments and information as may be necessary to keep Congress informed of the operations and financial condition of the several corporations together with such recommendations with respect thereto as the Comptroller General may deem advisable including a report of any impairment of capital noted in the audit and recommendations for the return of such Government capital or the payment of such dividends as in his judgment, should be accomplished The report shall also show specifically any program, expenditure, or other financial transaction or undertaking observed in the course of the audit, which, in the opinion of the Comptroller General, has been carried on or made without authority of law . . . .

FHLBB

31 U.S.C. § 67(a) provides that, except as otherwise specifically provided by law, the financial transactions of each executive, legislative and judicial agency shall be audited by the General Accounting Office. The term "executive agency" encompass the Bank Board because that term is defined as including "independent establishments in the executive branch of the government." 31 U.S.C. § 65a, and the Bank Board is defined as such as "independent agency in the executive branch of the government" by 12 U.S.C. § 1437(b). (Cf. 31 U.S.C. § 67(e) which provides for GAO audit of the Federal Reserve Board, FDIC, and Office of the Comptroller of the Currency).

31 U.S.C. §66a(a) requires the head of each such executive agency to establish and maintain systems of accounting and internal control designed to provide among other things: (1) full disclosure of the financial results of the agency's activities; (2) adequate financial information needed for the agency's management purposes; and (3) effective control over and accountability for all funds, property, and other assets for which the agency is responsible, including appropriate internal audit.

QUESTION 3

Time period for losses to be covered -- what does FSLIC do under existing ICC program?

ANSWER 3

Thus far the use of the Income Capital Certificate (ICC) Program has been limited to the "Phoenix Associations". In each of these Phoenix Associations the coverage of losses is wholly discretionary with the FSLIC and the FSLIC retains the right to merge or sell all or part of the Phoenix at anytime.

QUESTION 4

ABA testified banks with a high percentage of residential mortgage loans should be able to become members of the appropriate FHLBank. What does the Bank Board think?

ANSWER 4

If the process of homogenization of financial intermediaries continues, then bank membership of all institutions involved in mortgage lending should be evaluated. Thus, the twelve Federal Home Loan Banks could become housing banks that would serve all housing lenders, just as the Federal Reserve is the ultimate central credit facility for all regulated financial intermediaries.

Federal Home Loan Bank Board

Questions from Senator Riegle to Chairman Pratt

Question 1: I understand that the Bank Board, through its Income Capital Certificate Program, already has provided capital assistance in a few selected cases. What does S. 2531, as introduced, add to your powers that you don't already have?

Answer: In providing financial assistance to insured institutions under existing law, the Bank Board is restricted by the requirement in 12 U.S.C. Section 1729(f) that FSLIC expenditures of this kind, in effect, must be made only with respect to institutions in default or in danger of default. While there obviously is a considerable amount of flexibility in such a standard, the Bank Board believes that, if Congress desires implementation of an industry-wide assistance program for institutions at or below the 3 percent net worth level, it would be preferable to enact explicit, authorizing language of the type contained in S. 2531. Depending on the particular circumstances of an institution, we are concerned that the provision of capital assistance to an institution with net worth in the 3 percent, or even 2 percent, range, could be open to serious question under current law with respect to its legitimacy as a default prevention action.

S. 2531 also would ensure that insured institutions chartered under state law would be able to receive capital assistance on an effective basis despite state laws and regulations that might otherwise act as a barrier to such help. Absent the state law override provision in the bill, the Bank Board believes that some state-chartered institutions might be unable to issue the income capital certificates that are an integral part of the contemplated S. 2531 assistance plan, or might not be able to utilize the assistance to meet state-imposed regulatory net worth requirements. While these problems could in many cases be dealt with by conversions to federal charters, the Bank Board does not wish for any capital assistance program to stimulate disruptions in the dual system.

Questions from Senator Riegle from Chairman Pratt
Continued

uestion 2: What is your best estimate as to the number of associations that are currently below half of one percent in net worth and how many do you think there will be by the end of this year? Also, what is the estimated dollar amount of assets in these institutions?

nswer: At the end of April 1982, there were 119 FSLIC-insured savings and loan associations with net worth below half of one percent; these inst tutions had assets aggregating $31 billion. If operating losses cont nue at about the present pace during the remainder of the year, in the absence of any capital assistance program the number of associations with net worth ratios below half of one percent will likely rise to about 220 with assets of $42 billion.

uestion 3: Why should an institution have to agree to a merger or reorganization in advance before receiving any assistance under S. 2531? At the present time, the law requires that net worth (or reserves) be at least 3 percent. Would it help to authorize net worth requirements between zero and 6 percent?

nswer: See attached letter from Chairman Pratt to Mr. William O'Connell dated June 14, 1982.

Institutions' true economic condition would not be helped merely by altering the statutory net worth requirements. However, if Congress should choose to change the net worth percentages, this would not pose any significant problems for the Bank Board.

One of the primary reasons the Bank Board prefers the partial loss coverage approach of S. 2531 to the full ma ntenance that wou d be provided under H.R. 6267 is that under S. 2531 nterna incentives to effective management would be preserved, thus avoiding the need for the extensive bureaucrat c intrusion into operational decisions--including mergers and reorganizations--that we believe is implied in H.R. 6267.

Page Three

Questions from Senator Riegle to Chairman Pratt
Continued

Question 4: S. 2532, the Deposit Insurance Flexibility Act, recommends that mergers, consolidations, transfers and acquisitions be considered in the following sequence:

> "First, between institutions of the same type within the same State; second, between institutions of the same type in different States; third, between institutions of different types in the same State; and fourth, between institutions of different types in different States."

Why shouldn't intrastate mergers and acquisitions be considered before any interstate transactions? In other words, why shouldn't the priorities be reversed so that preference is given first to institutions of the same type within the same State; second, to institutions of different types in the same State; third, to individuals in the same State; and only then to institutions of the same type in different States and institutions of different types in different States?

Answer: The Bank Board recognizes that there are two legitimate schools of thought on this issue: (1) those who believe that preservation of the identity of the savings and loan industry, with its commitment to housing, is most important; and (2) those who believe that it is more important to prevent depository institutions from spreading across state boundaries. The Bank Board feels that it would be less disruptive to the current structure of the financial system than the alternative, particularly with respect to the provision of housing credit. Moreover, we wished to avoid an undue bias against interstate acquisitions because such transactions -- or their realistic possibility -- have had the effect of greatly improving the terms upon which in-state institutions are willing to acquire financially troubled institutions.

Question 5: S. 2531 states that no assistance may be provided to a financially distressed institution if the Federal Savings and Loan Insurance Corporation determines that providing such assistance would be costlier than liquidating such institution. How do you plan to measure the cost of

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Questions from Senator Riegle to Chairman Pratt
Continued

Answer: Con't. comparision with the cost estimates of the Receivership Model may be made.

Question 6: Under what circumstances would you envision that the FSLIC would purchase capital instruments from a qualified institution in an amount more than 50 percent of such institution's actual losses?

Answer: The currently proposed assistance program does not envision the purchase of capital instruments from a qualified institution by FSLIC in an amount in excess of 50 percent of such institution's actual losses.

Question 7: What procedures are currently being followed by the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation in dealing with financially distressed institutions? How are procedures adopted?

Answer: The process of dealing with financially distressed associations begins well in advance of the time when an association will become insolvent. Once a problem association is identified the local supervisory agent will begin to work closely with the association's board of directors and management to take all reasonable means to resolve the association's problems. These include cutting operating costs, restructuring the portfolio, raising new capital or seeking a voluntary merger with a stronger institution.

See attached May 1982 Memo from H. Brent Beesley, D. James Croft and Thomas P. Vartanian to Supervisory Agents, OES Staff, FSLIC Staff and OGC Staff.

Questions from Senator Riegle to Chairman Pratt
Continued

Question 5: Con't. providing assistance versus the cost of liquidating an institution?

Answer: The FSLIC has used financial computer modeling to determine the anticipated cost of solving a problem situation. Costs are computed in net present value terms so that relevant comparisons can be made of the many alternatives that may be available to the FSLIC.

To measure the cost of providing assistance versus the cost of liquidating an institution, two separate financial models are utilized. The Receivership Model simulates the costs to the FSLIC over the project life of the receivership. The model accounts for the initial FSLIC cash outflows experienced during a receivership to pay the insured savers and associated expenses. After the initial outflows current expenses are paid by the receivership. Income, losses and operating expenses are projected as they are likely to occur and cash distributions to the FSLIC are projected as sufficient cash is anticipated to be accumulated by the receiver from operations. The net cash return from the receivership to the FSLIC is then computed. This cash is discounted at the Corporation's opportunity cost of capital, and the cost estimate of a liquidation is then made.

Our Financial Assistance Agreement (FAA) model embodies the provisions that the FSLIC is likely to consider in an assisted merger or other assistance that it is structuring. When an FSLIC assisted proposal is submitted, selected financial items such as capital losses and operating losses that have been an impact on the amount of capital assistance necessary are analyzed. The cost of each infusion is computed through the use of the simulation process. Any cash outflow from the FSLIC to the qualifying association is also determined.

The FAA Model is then used in conjunction with the S&L Viability Model. Used in this fashion, the projected results of the assisted association are evaluated over time and payback from net income is computed. The net cash flow (the difference between outflows and inflow) is converted to net present value so that a direct

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Questions from Senator Riegle to Chairman Pratt
Continued

Answer: Con't. The current procedures were adopted pursuant to the statutory mandate of the FSLIC under Section 406(f) of the National Housing Act, as amended, and consistent with Bank Board policy in Resolution 81-157. The policies are frequently reviewed by the FSLIC in consultation with the Board Members and with input from the Office of Examinations and Supervision, the Office of General Counsel, the twelve Federal Home Loan Bank Presidents and Supervisory Agents in the field.

Question 8: If a well-run institution's net worth is deteriorating each year, wouldn't it make more sense to maintain net worth at 1 percent or 2 percent rather than give them half of their net worth loss so that in another year or so they would be out of net worth?

Answer: As we testified, the Bank Board believes that the interests of the public and the savings and loan industry will best be served by an approach to assistance that maintains internal pressure on institutions to minimize costs and avoid losses, and thereby reduces the need for bureaucratic oversight. An assistance program that covers all losses and maintains a specified net worth percentage would increase costs and eliminate any sense of urgency among institutions to take steps necessary to assure their own long-run competitive viability.

Question 9: What procedures are currently being followed with respect to mergers, consolidations, transfers and acquisitions of financially distressed institutions?

Answer: See attached May 1982 Memo from H. Brent Beesley, D. James Croft and Thomas P. Vartanian to Supervisory Agents, OES Staff, FSLIC Staff and OGC Staff.

Question 10: It seems to me that the House bill and S.2531 embody diametrically opposed approaches to the problems of the thrift industry. The House bill would support capital at 2 percent and restrict the Bank Board from merging institutions that are viable in the long run. S. 2531 provides, really, for limited assistance for solvent institutions. There seems to be an underlying philosophy

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Questions from Senator Riegle to Chairman Pratt
Continued -

Question 10: Con't. in S. 2531 that mergers and restructuring are the solution to the thrift problem and assistance is given to temporarily contain the scope of the merger problem, as if the problem were one of the Bank Board managing the hundreds of mergers expected. What about these opposing approaches? First of all, is there a difference in approach? And, second, are forced mergers the solution to a problem caused by high interest rates?

Answer: As we indicated in our testimony, the Bank Board prefers the S. 2531 approach because we believe it is less expensive, implies less bureaucratic intrusion into association affairs, and is structured to allow non-viable institutions to fail while permitting viable associations to remain in business. S. 2531, in our view, would provide the minimum amount of assistance needed to prevent the current situation from becoming unmanageable and thus dangerous to the nation's economic health. H.R. 6267, in our view, would act to retard tendencies, such as a trend toward mergers, that would act to strengthen the industry's ability to cope with the current crisis. Regarding your question as to the merits of mergers, the question of increased financial consolidation raises a variety of important issues which it would be in the national interest for Congress to resolve. In terms of our own actions, mergers represent the most important way for the Bank Board to achieve the Congressionally-imposed objective of conserving the FSLIC's insurance fund. Mergers do allow the buying of some time, however, if high interest rates persist over a period of years, many thrifts as well as other financial institutions, will have difficulty preserving profitability.

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

RICHARD T. PRATT
CHAIRMAN

JUN 14 1982

Mr. William B. O'Connell
President
United States League of
Savings Associations
111 East Wacker Drive
Chicago, Illinois 60601

Dear Mr. O'Connell:

Thank you for your letter of June 7, 1982, concerning pending thrift institution assistance as incorporated in Senate Bill 2531. Regarding your concern about the imposition of supervisory controls under the net worth assistance plan of S. 2531, I do not believe such controls would be appropriate for eligible institutions under either a capital assistance (S. 2531) or capital maintenance program (H.R. 6267). Specifically, I believe the Board should not seek as a routine prerequisite to either capital assistance or capital maintenance a merger resolution, conditions regarding the election of officers and directors, or execution of a Master Agreement permitting the FSLIC to merge the assisted institutions at its discretion.

As you noted, these prerequisites are often required by the Board in its default prevention activity when Income Capital Certificates are involved. Such controls would seem to be unnecessary under either kind of statutory assistance program. Currently, ICCs are issued on a case-by-case basis in the course of the Board's default prevention activities for failed associations when it is the Board's judgment that such a solution is appropriate. In such circumstances, supervisory controls are implemented to protect FSLIC's interests.

In contrast, the capital assistance and capital maintenance bills envision that assistance would be available to a very large group of institutions falling below predetermined net worth levels. Indeed, it was the Bank Board's desire to avoid inordinate supervisory burdens which led to our support of S. 2531's relatively objective, uncomplicated eligibility requirement. Under this criterion, the Board would determine that an institution would remain solvent for more than six months.

The Bank Board would prefer to avoid heavy regulatory oversight in connection with Congressional assistance plans. However, as I recently testified before the Senate, I am concerned that a capital maintenance program would by its nature require additional examination or supervisory oversight in areas such as expense control.

Regarding your query about the "solvency in six months time" test of S.2531, I believe a business plan supporting management's forecast of recovery could be helpful in the Board's continuing effort to work with all institutions to maximize their chances of success and recovery from the current business cycle. Whether such a plan would be required by the Board under S.2531 is a matter still under consideration.

I hope this response adequately addresses the issues raised in your letter.

Sincerely,

Richard T. Pratt

Richard T. Pratt
Chairman

Federal Home Loan Bank Board

Memo

INTER-OFFICE COMMUNICATION

FROM:	H. Brent Beesley D. James Croft Thomas P. Vartanian	DATE	May 1982
TO	Supervisory Agents OES Staff FSLIC Staff OGC Staff	SUBJECT:	Guidelines & Procedures for the Resolution of Supervisory Cases

This memorandum is a restatement of the policies and procedures detailed in our February 2, 1982 memorandum. Since our policies and procedures should remain fluid in the current environment, we would encourage you to please submit any suggested modifications to either Tom Timmins in OES or Gene Hall in FSLIC.

I. Solutions for Supervisory Cases in Order of Preference

A. New Capital

New capital to rebuild the net worth of an association is considered to be the most desirable solution. In February OGC redefined its guidelines and procedures on supervisory conversions and also expanded the ability of stock institutions to acquire failing mutuals prior to zero net worth.

Supervisory conversions are permissible in those associations which can be projected to exhaust their net worth in eleven months or less on the basis of an earnings projection using the interest rate assumptions provided monthly by the Bank Board. The minimum capital infusion must equal at least three years of operating losses based upon a projection using the interest rates supplied monthly by the Board. If permissible under GAAP, purchase accounting may be used in a supervisory conversion.

Supervisory conversions in which current directors, officers, and employees become stockholders involve a number of legal problems which will be discussed in a separate memorandum.

B. Acquisitions

Acquisitions involving capital infusions (*i.e.*, where the strong capital position of the acquirer supports the failing institution) are very desirable. Every effort should be made to facilitate acquisitions by financially strong individuals and companies including banks and bank holding companies (see below).

C. Mergers into Strong FSLIC-Insured Associations

The following represent the priorities for mergers:

1. Voluntary Non-supervisory In-state Mergers

2. Supervisory In-state Mergers

1. "Marginally" assisted In-state Mergers

"Marginal assistance" varies substantially from market area to market area and may also vary depending upon the structure of the proposed assistance. It must be addressed on a case-by-case basis. In some cases the FSLIC may predetermine the level of assistance and then solicit and evaluate bids on the basis of viability and business plans.

B. Interstate, Inter-industry, & CAM

Each of these is considered on an equal footing with preference given to the most viable, cost effective alternative.

1. Interstate Mergers

Interstate mergers will not be approved for less than [illegible] million in problem assets.

2. Acquisitions by Banks and Bank Holding Companies

The Bank Board and the Federal Reserve have yet to approve a solution of this type. FSLIC and OGC staff are prepared to recommend this as a solution. Pursuant to current FHLBB policy, in-state acquisitions will be given preference to out of state acquisitions.

3. Continuously Approved Merger (CAM).

These are supervisory, in-state mergers of financially weak associations which on the basis of purchase method accounting are able to forecast viability for three years. Such a merger, in order to be approved, must result in an association which can survive three years of operating losses based upon an earnings projection using the interest rate assumptions which will be supplied by the Board on a monthly basis. The approval of these mergers should require the imposition of conditions deemed appropriate by local supervision, such as, the adoption of a six-month merger resolution, the authority for the FSLIC to name one or more directors, the submission of a detailed business plan, and the submission of periodic budgets and other financial reports.

E. The CASMICC

The CASMICC (a cross between a CASM, a Phoenix and an assisted merger) is a supervisory, in-state combination of financially weak associations which does not meet the three year viability test but does demonstrate a substantial possibility of long-range recovery given some temporary FSLIC net worth support.

The CASMICC must have proven, competent management and must submit an acceptable long-range business plan which demonstrates an ability to reduce unnecessary expenses, consolidate operations, restructure its assets and liabilities, and return to profitability within 5 years. These must be good, solid plans demonstrating survivability. The CASMICC must agree to accept additional controls should it fail substantially in any annual period to meet the goals and projecticins of its business plan. In addition the CASMICC must agree to FSLIC representation on its Board of Directors.

F. "Clean Balance Sheet" Acquisitions

A "Clean Balance Sheet" transaction is a form of acquisition wherein a successor institution assumes essentially all liabilities and the FSLIC acquires the bulk of the assets of the disappearing association. The FSLIC would probably only issue notes in lieu of cash to the S&L that assumes the liabilities. The rate on these notes would be negotiated to approximate the cost of money related to the deposits assumed.

G. "Phoenix" Plan

The "Phoenix" Plan will be used first as an emergency holding pattern where state action or a liquidity crisis requires immediate action, and/or second in severely depressed market areas, where the number and/or magnitude of problem associations precludes other solutions.

The association grants the FSLIC the authority to merge or sell the association anytime, to replace management and the board of directors, and to review and veto operational decisions and plans.

H. Liquidation and Payout of Insurance

Liquidation, accompanied by the payment of insurance, will be used when and if there is no less costly alternative available.

II. <u>Procedures to be followed by Supervisory Agents in Resolving Problem Cases</u>

<u>Step 1</u>

On a monthly basis, prioritize in order of urgency your projected insolvency cases out to at least 24 months. This list should be communicated to OSS through your OSS Regional Director. (If there are significant problems of a non-financial nature in a given problem association, develop a strategy with OSS rather than follow the steps below.) At least monthly, this list will be reviewed in a conference call with OSS, FSLIC and OGC personnel to coordinate strategies, policy and timetables. In addition any questions, clarifications, or changes in these procedures should be raised at this meeting.

<u>Step 2</u>

Starting with your worst cases, but including those up <u>to 24 months</u> to insolvency, meet with the boards of directors of these associations and discuss the problem with them. You should arrange this meeting with the state supervisor of state chartered associations.

Encourage conversion to stock form, pledged savings, infusion of capital and/or other arrangements as considered appropriate in order to resolve the institution's financial problems. If a merger is the planned course, you should provide the association with a list of in-state merger candidates which are financially and managerially capable of acquiring it and which will be viable after the merger. Supervisory Agents are encouraged to cultivate and maintain lists of potential merger partners or acquirers both in-state and out-of-state. Assure yourself through a review process that good faith efforts to achieve a voluntary solution to the problem are underway. Obtain the short form merger resolution if appropriate. Not later than 12 months to insolvency, establish a definite plan with the association and a date after which additional supervisory action will be taken if the association is not successful in the plan as established. If the association's board adopts no reasonably practical or achievable plan to resolve its own financial problems, obtain the final merger resolution at this time. Otherwise, you may wait until the association has exhausted the agreed upon time period. <u>Notwithstanding voluntary efforts by the problem association, the final merger resolution should be obtained when insolvency is projected within six months.</u> There should be no discussion of any FSLIC capital assistance since the objective is to resolve the problem in other ways.

<u>Note:</u> If the board of directors is not willing to adopt the final merger resolution at six months to insolvency, the matter should be brought to the attention of the OSS and FSLIC Regional Directors immediately, and a recommendation to take enforcement action should be made to the OSS Regional Director.

Step 3

If Step 2 does not result in a solution, contact all viable candidates that are FSLIC insured institutions within the state and all identified potential private investors and corporations. Attempt to negotiate an unassisted merger or acquisition. Those associations and investors which indicate an interest should be supplied financial data sufficient to make a preliminary judgment. (See SP-8 for guidance on supplying financial data to interested parties.)

Step 4

If Step 3 is not successful, prepare the Bidders' Package using the FSLIC standard Form as a guide and contact all associations which are eligible and/or have indicated an interest in considering an assisted merger or acquisition of the problem institution. The Bidder's Package should be complete and professional in appearance and approach. Similarly, any interested private investors should be contacted regarding an assisted acquisition. When feasible, all eligible interested in-state associations and investors should attend a bidders' conference. If conditions mitigate against such a meeting, the Bidders' Package may be distributed by mail with follow-up by personal visit or telephone contact by the Supervisory Agent. In either case, a definite date and time must be set for receipt of bids. The reasons for including or excluding potential bidders must be consistent and documented

Note: In-state associations when making an assisted bid should clearly understand their first bid should be their best bid. If in-state bids are not acceptable and an acceptable interstate bid is received, it will not be reshopped with the in-state associations.

Step 5

With the help and direction of the FSLIC Regional Director, as needed, analyze the bids and send the three most advantageous and least costly completed bids to Washington to be costed. Also send in for the record the rejected bids as well. If there are issues remaining to be negotiated on a given bid, you will negotiate same with the support of the FSLIC and OGC staff. Supervisory Agents will be responsible for contacting all bidders as to the results of the bidder's process. Similarly, if there appears to be a substantial delay in the evaluation of bids, bidders should be notified and advised of the anticipated delay.

Step 6

If, after receiving and analyzing the bids, FSLIC finds no proposal to be acceptable, your FSLIC and/or OES Regional Directors will contact you regarding a CASM, and/or potential inter-industry or interstate acquirers, both within your District and nationwide. Since in-state shopping has been completed, efforts to negotiate an interstate acquisition will be undertaken by the Washington office of FSLIC. You will be kept informed of all contacts and all requests for specific information will be referred to you as the Supervisory Agent.

__Step 7__

If no acceptable merger or acquisition can be negotiated, consideration will be given to the formation of a "[illegible]", a "Phoenix" association or a "Clean Balance Sheet" acquisition prior to consideration of a liquidation and payout of insured accounts. The Supervisory Agent through the FSLIC Regional Director will be kept fully informed and will participate in preparing the recommended course of action.

__Note__: Each District should develop and maintain a list of personnel who might be considered for management and directorates in the event a "CMP" or "Phoenix" is deemed necessary.

III. __Division of Supervisory Responsibilities - OES, FSLIC and Supervisory Agents__

Frequent, and clear communication, and total cooperation among the supervisory personnel and their respective OES and FSLIC Regional Directors are essential. The following guidelines are set forth to clarify and aid in this direction:

1. OES and FSLIC are routinely referring associations and investors to Supervisory Agents to obtain information on problem associations. Every accommodation must be given to these potential suitors. We need them, and we must try to provide them with all the names and information we can to help them help us.

2. Copies of letters and memoranda to or from the Districts or between offices which involve any of the parties should be exchanged with all parties. The content of pertinent telephone conversations should be memorialized and relayed to the Regional Directors and/or supervisory personnel not present at the time. FSLIC and OES should invite each other to meetings concerning cases involving both and communicate the outcome of such meetings with the field. Regional Directors will be responsible for communicating to the Supervisory Agents the results of meetings or actions in Washington.

3. Supervisory Agents have the responsibility for (1) developing a plan of action with respect to problem associations in their districts, and (2) obtaining a consent merger resolution __no later than six months prior to insolvency__ and attempting to negotiate a merger once the resolution is in hand. During this process and until it is determined that FSLIC financial assistance or interstate or interindustry activity will be necessary to resolve the problem case, the Supervisory Agent should deal primarily with the OES Regional Director. If an association proposes to adopt a consent merger resolution which differs from the standard resolution, the Supervisory Agent should inform the OES Regional Director, who will then have the responsibility of clearing the proposed resolution with the FSLIC Regional Director and the Office of General Counsel.

4. The Supervisory Agent is responsible for preparing a list of the associations to be contacted about a potential acquisition or in-state merger on either an unassisted or assisted basis. This effort should receive the concurrence of the OES Regional Director. The criteria for selection of potential acquirees must be documented and the rationale for exclusion of other associations within the state must be reasonable and objective.

5. Once the Supervisory Agent and the OES Regional Director have determined that FSLIC financial assistance will be needed or an interstate or inter-industry solution will be required to resolve a problem, the OES Regional Director should prepare a memorandum recommending that the case be transferred to the FSLIC. This memorandum should be consistent with the procedures set forth in the OGC's memorandum of February 2, 1982 supplementing this memorandum, and include a general summary as to the identity of the associations contacted concerning an unassisted merger and their interest, or lack of interest, in an assisted merger. The field should receive a copy of these memoranda.

6. The Supervisory Agent should deal with the FSLIC Regional Director after the case has been formally transferred to the FSLIC. This transfer will involve only the problem solving aspect, i.e., the negotiation of an assisted merger, an interstate merger or some other solution involving FSLIC financial assistance. Other supervisory responsibilities will remain under the control of the Supervisory Agent and OES.

7. If an association proposes a merger plan that involves FSLIC financial assistance prior to the actual transfer of the case to the FSLIC, the Supervisory Agent should discuss the matter with the FSLIC Regional Director. Questions involving subordination agreements, and the preparation and content of Bidders' Packages also should be addressed to the FSLIC Regional Director. However, the OES Regional Director should be kept informed of these matters.

8. The FSLIC is prepared to recommend to the Bank Board subordination to or guarantee of District Bank advances in cases where doing so is essential to avoid a liquidity crises at an institution and when there is a final consent merger resolution in hand. If a deposit outflow or other binding commitment arises which requires Bank advances to an association to maintain its liquidity and if the advances could not safely be made pursuant to that Bank's credit guidelines, the FSLIC should be asked to subordinate or guarantee such advances. An association must provide a consent merger resolution before the FSLIC will consider these subordinations or guarantees.

[illegible] 2 [illegible] 21, 198[illegible]

MEMORANDUM TO: All Supervisory Agents

FROM: H. Brent Beesley
Director, FSLIC
and
[illegible] James [illegible]
Director, OEI

SUBJECT: Standard Guidelines and Procedures for the Resolution of Problem Cases

This memo supersedes the memo dated April 22, 198[illegible], regarding "FSLIC Capital Infusion Program Implementation Procedures" and also the draft memo of August 21, 198[illegible]. (This memo is still in draft form and will be finalized on the basis of input received from supervisory agents at the New Orleans meeting.)

Several things are being done in Washington to facilitate the resolution of supervisory problems. These things are outlined in the first section of this memo. In addition, many basic approaches can be used in solutions. These approaches are outlined in the second section. Finally, the third section presents a step-by-step procedure for approaching your supervisory cases.

<u>Changes in Washington to Facilitate Solutions.</u>

A. In addition to regional directors for supervision, we now have regional directors for FSLIC. The OEI and FSLIC regional directors will work to carry out several major responsibilities in dealing with supervisory cases. Among others, these include:

1. Monitoring the implementation of the newly delegated responsibilities to the district personnel. They will answer questions and work out problems with the process as they arise.

2. Making decisions in unclear cases as to whether cases can be handled at the district or the Washington level.

3. Making decisions about whether unassisted supervisory actions are to be supplemented with FSLIC assistance.

4. Monitoring the activities in Washington associated with the preparation and presentation of any required Board actions.

B. Standardization of forms and procedures is under way. Past supervisory actions and FSLIC assistance have been handled on a job-shop basis. Standardization of processes and the forms used in supervision and assistance is required to convert these functions to a production-shop basis. Standard forms are being designed to direct the parties to the real issues and to avoid undue negotiation and expense on drafting and structuring. It is possible that unique situations may arise which require changing a standard form. This, however, may require time consuming approval from OGC, OES and FSLIC, and should be avoided if possible.

C. Processing of mergers has been delegated to a greater extent to the District Banks. Requirements for review in Washington have been reduced. Impediments to the merger process must continue to be eliminated to the fullest extent legally possible. All unassisted mergers which can be handled at the district level should be expedited and those which must be approved in Washington will also be handled as rapidly as possible. (OES and FSLIC will continue to lobby for further delegation of merger approval to the field.)

D. The FSLIC is prepared to subordinate or guarantee District Bank advances in cases where doing so would avoid a liquidity crisis at an institution. If a deposit outflow or other binding commitment arises which requires Bank advances to an association to maintain its liquidity and if the advances could not safely be made pursuant to that Bank's credit guidelines, the FSLIC should be asked to subordinate or guarantee such advances. Except in emergency situations, an association must provide a merger resolution before the FSLIC will consider these subordinations or guarantees.

I. Approaches to Solutions.

There are several basic approaches to dealing with severe supervisory problems. These are outlined below in a rough order of priority.

A. Mergers and Acquisitions.

The basic strategy of the FHLBB and the FSLIC staff is to resolve problem cases through the merger and acquisition process. Unassisted mergers are clearly preferable to assisted mergers. The rationale for this strategy is as follows:

1. A merger or acquisition, if properly structured, will result in a surviving association that will be viable in any anticipated economic scenario;

2. A merger is generally not disruptive to the public and no depositors will lose money;

3. Most mergers do not require FSLIC financial assistance; and

4. Assisted mergers are generally less costly to the FSLIC than other assistance alternatives, since the cost of FSLIC assistance is reduced by the value of the franchise, branch network organization, etc.

B. Capital Infusion

Two types of capital infusion are possible: private capital infusion (including pledged savings) and FSLIC capital infusion.

1. Private capital infusion to build the net worth of an association should be proposed to the board of any troubled association. For stock institutions the first line of defense against capital erosion is always the current stockholders.

2. FSLIC capital infusion may be used in cases where there is no likelihood of a private infusion. It may also be used in conjunction with such private infusion (including pledged savings) and when there are no reasonable merger or acquisition prospects. To encourage the merger process, FSLIC capital infusion is envisioned only after a merger resolution has been received from the problem association and good faith efforts to negotiate a merger at reasonable cost to the FSLIC have not been successful. The management of an association which requires FSLIC capital will most likely be changed as circumstances dictate.

   Until there is more experience with the FSLIC capital infusion process, all associations which will be involved in this process will be handled through the FSLIC in Washington with support and assistance as requested from the supervisory personnel.

C. "Clean Balance Sheet" Agreement

A Clean Balance Sheet Agreement wherein the FSLIC purchases a substantial amount of assets to facilitate a merger is to be considered as a next-to-last resort, but may be used only if it is less costly to the FSLIC than a liquidation and payout.

D. Liquidation and Payout of Insurance

Liquidation, accompanied by the payment of insurance, will only be used when and if there are no less costly alternatives available. Every effort should be expended to avoid this alternative.

II. Procedures to be followed by Supervisory Agents in Resolving Problem Cases

Step 1

On a monthly basis, prioritize in order of urgency your Category I (12 months to insolvency) and Category II (24 months to insolvency) problem cases. This list should be communicated to OES through your Regional Director. You may receive input from the FHLBB regarding your list if data from the new FSLIC simulation model reveals a significant variance between your perceptions and the computer output. (The FSLIC model looks at future interest rate scenarios rather than current earnings to determine problem cases.) If there are significant special problems of a non-financial nature in a given problem association, develop a strategy with OES rather than follow the remaining steps below. (You are asked to report monthly on each of the associations per memo from David Taylor dated September 3, 1981.)

Step 2

Starting with your worst cases, meet with the boards of directors of your problem associations and discuss the problem with them. You should coordinate this meeting with the state supervisor of state chartered associations. Encourage them to convert to stock, pledge savings, infuse capital and/or make other arrangements in order to resolve their financial problems. If a merger is the planned course, you should provide the association with a list of in-state merger candidates which are financially and managerially capable and which will be viable after the merger. Assure yourself through a review process that good faith efforts to achieve a voluntary solution to the problem are underway.

Establish a definite plan and a date after which additional supervisory action will be taken if the association is not successful in the plan as established. If the association's board makes no plan to resolve its own financial problems, obtain a merger resolution at this time. Otherwise, you may

wait until the association has exhausted the agreed upon time period.

There should be no discussion of any FSLIC capital assistance as the objective is to resolve the problem in other ways.

Step 3

Make every effort to assist and expedite the association's efforts to solve its problems as per the plan outlined by the board of directors in Step 2 above.

Step 4

If the association plan is not accomplished as outlined or if no viable plan is established, obtain a merger resolution authorizing you as agent for the FSLIC to negotiate a merger. A model merger resolution is currently being produced for this purpose. This should be received at any rate at least six months prior to insolvency.

> <u>Note:</u> If it appears that the Board of Directors of the problem association is not willing to give a merger resolution, the matter should be immediately brought to the attention of OES and the FSLIC. A strategy will be developed for that association in cooperation with the supervisory agent involved.

Step 5

Contact all viable merger candidates (as determined by size, capital adequacy, management, earnings, etc.) that are insured by the FSLIC within the state of the problem association and attempt to negotiate an unassisted merger. If this fails, and the failing institution has assets greater than or equal to $100 million, then upon consultation with your regional directors, contact strong associations within your district. If successful, try to have the merger approved under the delegated merger authority or shepherd same through Washington.

Step 6

If Step 5 is not successful and the association has assets greater than $100 million, coordinate with your regional directors to develop a list of those associations located in other districts as well as non-FSLIC insured institutions, individuals or corporations that would be viable merger partners or acquirers. If requested to do so by OES and FSLIC in Washington, contact these parties through the supervisory agents in the districts which have jurisdiction over them or wherein they reside. Together,

negotiate an unassisted merger. If you feel that a given association with assets of less than $100 million should be merged across state lines, contact your regional directors.

Step 7

If step 6 is not successful, prepare a list of in-state institutions potentially interested in an assisted merger and obtain a list of the recommended out-of-state associations from FSLIC and OES. Contact these associations and determine those genuinely interested in merging with or acquiring your problem shop on an assisted basis. Supply the interested associations with a bidder's package which you have prepared per the model package currently being prepared by FSLIC.

Step 8

With the help and direction of the FSLIC regional director as needed, analyze the bids and send the three most advantageous and least costly completed bid forms to Washington to be costed, and presented to the Board for approval. Also send in for the record the rejected bid forms as well. If there are issues remaining to be negotiated on a given bid, you will negotiate same with the support of the FSLIC and OGC staff.

Step 9

If no other alternatives have been successful, you may be requested by FSLIC to contact the associations contacted in step 5 above for purposes of bidding on a P&A arrangement basis and/or to prepare documentation relative to a capital infusion or liquidation and payout of accounts by the FSLIC.

Federal Home Loan Bank Board

Memo

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

INTER-OFFICE COMMUNICATION

FROM: H. Brent Beesley
D. James Croft
Thomas F. Vartanian

TO: Supervisory Agents
OES Staff
FSLIC Staff
OGC Staff

DATE: February 2, 1982

SUBJECT: Guidelines & Procedures For the Resolution of Supervisory Cases

This memorandum is a restatement of the policies and procedures detailed in our October 15, 1981 memorandum and incorporates certain changes and modifications based on our collective experience since the New Orleans meeting. This represents current OES/FSLIC policy. Neither our policies nor our procedures should remain static in the current environment, however, so you should submit suggested modifications as we gain additional experience.

I. Solutions for Supervisory Cases in Order of Preference

A. New Capital

New capital to build the net worth of an association is considered to be the most desirable solution. The Office of General Counsel has redefined its guidelines and procedures on supervisory conversions and has now expanded the ability of stock institutions to acquire failing mutuals prior to zero net worth. These concepts are separately discussed in this memorandum and may be utilized in solutions I(A) to I(D).

B. Acquisitions

Acquisitions involving private capital infusions are very desirable. Every effort should be made to facilitate acquisitions by financially strong individuals and companies (except banks and bank holding companies - see below).

C. Mergers into Strong FSLIC-insured Associations

The following represent the priorities for mergers:

1. Voluntary Non-supervisory In-state Mergers

2. Voluntary Unassisted In-state Mergers

3. Involuntary Unassisted In-state Mergers

4. "Marginally" Assisted In-state Mergers

5. Unassisted Interstate Mergers

6. "Marginally" Assisted Interstate Merger

7. Conditionally Approved Supervisory Mergers ("CASM")
To be discussed.

8. Assisted Mergers

D. Acquisitions by Banks and Bank Holding Companies

The Bank Board and the Federal Reserve have yet to approve a solution of this type. FSLIC and OES staff are prepared to recommend this as a solution. See Step 6.

E. "Phoenix" Plan

To be discussed.

F. "Clean Balance Sheet" Acquisitions

A "Clean Balance Sheet" transaction is a form of acquisition wherein a successor institution assumes essentially all liabilities and the FSLIC acquires the bulk of the assets of the disappearing association. It will be considered only as an alternative to a liquidating receivership accompanied by a payout of insured deposits.

G. Liquidation and Payout of Insurance

Liquidation, accompanied by the payment of insurance, will only be used when and if there is no less costly alternative available.

II. Procedures to be followed by Supervisory Agents in Resolving Problem Cases

Step 1

On a monthly basis, prioritize in order of urgency your projected insolvency cases out to at least 24 months. This list should be communicated to OES through your OES Regional Director. (If there are significant problems of a non-financial nature in a given problem association, develop a strategy with OES rather than follow the steps below.) At least monthly, this list will be reviewed in a conference call with OES, FSLIC and OGC personnel to coordinate strategies, policy and timetables.

Step 2

Starting with your worst cases, but including those up to 24 months to insolvency, meet with the boards of directors of those associations and discuss the problem with them. You should arrange this meeting with the state supervisor of state chartered associations.

Encourage conversion to stock form, pledged savings, infusion of capital and/or other arrangements in order to resolve their financial problems. If a merger is the planned course, you should provide the association with a list of in-state merger candidates which are financially and managerially capable and which will be viable after the merger. Assure yourself through a review process that good faith efforts to achieve a voluntary solution to the problem are underway. Obtain the short form merger resolution if appropriate. Not later than 12 months to insolvency establish a definite plan with the association and a date after which additional supervisory action will be taken if the association is not successful in the plan as established. If the association's board makes no plan to resolve its own financial problems, obtain the final merger resolution at this time. Otherwise, you may wait until the association has exhausted the agreed upon time period. Notwithstanding voluntary efforts by the problem association, the final merger resolution should be obtained if insolvency is projected within six months. There should be no discussion of any FSLIC capital assistance since the objective is to resolve the problem in other ways.

Note: If the board of directors is not willing to adopt the final merger resolution at six months to insolvency, the matter should be brought to the attention of the OES and FSLIC Regional Directors immediately, and a recommendation to take enforcement action should be made to the OES Regional Director.

Step 3

If Step 2 does not result in a solution, contact all viable candidates that are FSLIC insured institutions within the state and all identified potential private investors and corporations. Attempt to negotiate an unassisted merger or acquisition. Those associations and investors which indicate an interest should be supplied financial data sufficient to make a preliminary judgment. (See SP-8 for guidance on supplying financial data to interested parties.) A definite time should be set for receipt of any unassisted proposal.

Step 4

If step 3 is not successful, prepare the Bidders Package and contact all associations which are eligible and have indicated interest in considering an assisted merger or acquisition of the problem institution. Similarly, any interested private investors should be contacted regarding an assisted acquisition. When feasible, all eligible interested in-state associations and investors should attend a bidders conference. If conditions mitigate against such a meeting, the Bidders Package may be distributed by mail with follow-up by personal visit or telephone contact by the Supervisory Agent. In either case, a definite date and time must be set for receipt of bids. The reasons for including or excluding potential bidders must be consistent and documented.

Step 5

With the help and direction of the FSLIC Regional Director as needed, analyze the bids and send the three most advantageous and least costly completed bid to Washington to be costed. Also send in for the record the rejected bids as well. If there are issues remaining to be negotiated on a given bid, you will negotiate same with the support of the FSLIC and OGC staff.

Step 6

If, after receiving and analyzing the bids, FSLIC finds no proposal to be acceptable, your FSLIC Regional Directors will contact you regarding potential interstate acquirers both within the District and nationwide. At this point, since in-state shopping has been completed, efforts to negotiate an interstate acquisition will be undertaken by the Washington office of FSLIC. You will be kept informed of all contacts and all requests for specific information will be referred to you as the Supervisory Agent. Also at this point consideration will be given to inter-industry, i.e., FDIC insured institutions and bank holding company acquisitions.

Note: In-state associations when making an assisted bid should clearly understand their first bid should be their best bid. If in-state bids are not acceptable and an acceptable interstate bid is received, it will not be reshopped with the in-state associations. In most cases, interstate proposals will involve more than one association.

Step 7

If for whatever reason no acceptable merger or acquisition can be negotiated, consideration will be given to the formation of a "CASM" association, a "Phoenix" association or a "Clean Balance Sheet" acquisition prior to liquidation and payout of insured accounts. The Supervisory Agent through the FSLIC Regional Director will be kept fully informed and will participate in preparing the recommended course of action.

Note: Each District should develop and maintain a list of personnel who might be considered for management and directorate in the event a "CASM" or "Phoenix" is deemed necessary.

III. Division of Supervisory Responsibilities - OES, FSLIC and Supervisory Agents

To sustain momentum and achieve the desired result, i.e., acquisition or merger of problem shops at no or minimal cost to the Insurance Fund, frequent, clear communication and total cooperation among the Supervisory Agents and their respective OES and FSLIC Regional Directors are essential. The following guidelines are set forth to clarify and aid in this direction:

1. OES and FSLIC are referring associations and investors to the Supervisory Agent to obtain information on problem associations. Every accommodation must be given to these potential suitors. We need them, and we must try to provide them with all the names and information we can to help them help us.

2. Copies of letters and memoranda to or from the Districts or between offices which involve any of the parties should be exchanged with all parties. The content of pertinent telephone conversations should be relayed to the Regional Directors and/or supervisory personnel not present at the time. FSLIC and OES should invite each other to meetings concerning cases involving both and communicate the outcome of such meetings with the field.

3. Supervisory Agents have the responsibility for (1) developing a plan of action with respect to problem associations in their districts, and (2) obtaining a consent merger resolution no later than six months prior to insolvency and attempting to negotiate a merger once the resolution is in hand. During this process and until it is determined that FSLIC financial assistance or interstate activity will be necessary to resolve the problem case, the Supervisory Agent should deal primarily with the OES Regional Director. If an association proposes to adopt a consent merger resolution which differs from the standard resolution, the Supervisory Agent should inform the OES Regional Director who will then have the responsibility of clearing the proposed resolution with the FSLIC Regional Director and the Office of General Counsel.

4. The Supervisory Agent is responsible for preparing a list of the associations to be contacted about a potential acquisition or in-state merger on either an unassisted or assisted basis. This effort should receive the concurrence of the OES Regional Director. The criteria for selection of potential acquires must be documented and the rationale for exclusion of other associations within the state must be reasonable and objective.

5. Once the Supervisory Agent and the OES Regional Director have determined that FSLIC financial assistance will be needed or an interstate solution will be required to resolve a problem, the OES Regional Director should prepare a memorandum recommending that the case be transferred to the FSLIC. This memorandum should be consistent with the procedures set forth in the OGC's memorandum of February 2, 1982 supplementing this memorandum, and include a general summary as to the identity of the associations contacted concerning an unassisted merger and their interest, or lack of interest in an assisted merger. The field should receive a copy of these memoranda.

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6. The Supervisory Agent should deal with the FSLIC Regional Director after the case has been formally transferred to the FSLIC. This transfer will involve only the problem solving aspect, i.e., the negotiation of an assisted merger, an interstate merger or some other solution involving FSLIC financial assistance. Other supervisory responsibilities will remain under the control of the Supervisory Agent and OES.

7. If an association proposes a merger plan that involves FSLIC financial assistance prior to the actual transfer of the case to the FSLIC, the Supervisory Agent should discuss the matter with the FSLIC Regional Director. Questions involving subordination agreements, and the preparation and content of Bidders' Packages also should be addressed to the FSLIC Regional Director. However, the OES Regional Director should be kept informed of these matters.

8. The FSLIC is prepared to recommend to the Bank Board subordination to or guarantee of District Bank advances in cases where doing so is essential to avoid a liquidity crises at an institution <u>and</u> when there is a final consent merger resolution in hand. If a deposit outflow or other binding commitment arises which requires Bank advances to an association to maintain its liquidity and if the advances could not safely be made pursuant to that Bank's credit guidelines, the FSLIC should be asked to subordinate or guarantee such advances. An association must provide a consent merger resolution before the FSLIC will consider these subordinations or guarantees.

Federal Home Loan Bank Board

Questions from Senator Proxmire to Chairman Pratt

Question 1: It would appear that there will be more savings and loan associations merged out of existence under the S. 2531 partial assistance formula than would be merged under the House approach of a 2 percent net worth capital floor for institutions that are viable in the long run. How many institutions would be merged out of existence under each approach?

Answer: The following table projects the number of FSLIC-insured associations that would have reached 0 net worth by year-end 1982-86 under S. 2531 and H.R. 6267 under two interest rate scenarios — (a) Treasury bill rates average about 9-1/2 percent and (b) Treasury bill rates average about 13-1/2 percent. It is our belief that no viable associations will be forced out of existence under either approach.

	1982	1983	1984	1985	1986
9-1/2 Percent Interest Rates					
S. 2531	72	137	257	398	464
H.R. 6267	0	0	17	81	115
13-1/2 Percent Interest Rates					
S. 2531	147	464	1,108	1,698	2,116
H.R. 6267	0	0	1,031	1,943	2,336

Question 2: Will the issuance of FSLIC capital notes to support the capital of savings and loan associations suffice to instill public confidence in these institutions, without a full faith and credit commitment behind them, along the lines of the recent Resolution on insured deposits?

Answer: We believe that notes that are backed by the FSLIC's substantial resources will be sufficient to achieve the purposes of S. 2531. While backing them with the full faith and credit of the United States would be very helpful, such a step does not appear necessary at this time. Should obligations outstrip the present size of the FSLIC Fund then an increased credit line to Treasury would be required.

Page Two

Questions from Senator Proxmire to Chairman Pratt
Continued

Question 3: In the past you have argued for increasing the Bank Board's line of credit to Treasury, some say by as much as $10-20 billion. Why are you not recommending, at this time, a Treasury back-up to the FSLIC?

Answer: While the Bank Board in the past has argued for a more realistic line of credit to the Treasury, the Administration would prefer to avoid taking such a step until the need is imminent, given budget considerations. In light of the very rapid Congressional action on the full faith and credit resolutions, we are reasonably comfortable with this approach.

Question 4: Can you discuss the strength of the FSLIC insurance fund? How much is in the fund now, and how much in the way of contingent liabilities has the FSLIC committed itself under recent mergers? What is the gross amount of capital notes the FSLIC expects to issue under S. 2531 by the end of 1982? 1983? 1984?

Answer: At March 31, 1982, the insurance reserves stood at $6.452 billion. The strength of the fund, i.e., the ability of the fund to meet the FSLIC's insurance obligations, is a function of future interest rates and our continued ability to merge problem associations with more viable entities. If current interest rates continue for a prolonged period of time, we believe that the fund is sufficient to handle our insurance obligations at least through 1985.

Through March 31, 1982, the allowance for expected future contributions amount to $533 million. The remaining contingent liabilities for all assistance agreements in force at March 31, 1982 amounts to approximately $172 million.

This does not include any future purchases of ICC's that FSLIC may elect to make (but is not obligated to do so) with respect to the 5 "Phoenix" institutions. Under current economic conditions, FSLIC could potentially acquire an additional $900 million in ICC's over the next 10 years.

Questions from Senator Proxmire to Chairman Pratt
Continued

Answer: Con't. If Treasury bill rates average 8-1/2 percent over the next several years, it is estimated that pursuant to S. 2531 there would be $0.3 billion of capital notes outstanding at the end of 1982, $0.5 billion outstanding at the end of 1983, and $0.7 billion outstanding at the end of 1984. If Treasury bill rates average 13-1/2 percent, we estimate volume outstanding at $0.7 billion at the end of 1982, $2.4 billion at the end of 1983, and $4.66 billion at the end of 1984.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

June 21, 1982

Honorable Jake Garn
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
5300 Dirksen Senate Office Building
Washington, D.C. 20510

RE: S. 2531 and S. 2532

Dear Mr. Chairman:

We are pleased to respond to the additional questions you have submitted to us.

Question 1:

S. 2531 requires institutions receiving assistance to agree to comply with all terms and conditions established by the Corporation, including resolutions to merge or reorganize. The bill that was passed by the House essentially prohibits conditioning assistance upon such a resolution.

(a) How important is such a provision and would you continue to support this bill if it was amended to preclude such resolutions? Explain.

(b) What is your view on including a standard that is similar to the provision that was added to the House bill which allows the corporations to require such a resolution only if the institution receiving assistance has net worth of less than 1/2%?

Answer:

1(a): We believe it is quite important that the regulators have the authority to impose sanctions against management as a condition for receiving capital assistance. Under the House bill the assistance certificates represent a contingent liability for the U.S. Treasury. Under the Senate bill the contingent liability is against the respective deposit insurance funds. Either way the funds should be committed responsibly so that actual expenditures are kept to a minimum. Strict sanctions were authorized when Congress offered assistance to Lockheed, New York City, and Chrysler for this very reason and when we provide assistance under Sec. 13(c) of the FDI Act we impose conditions concerning operation of the institution. We believe this is a sound concept.

If you consider that of all the banks we supervise only about 250 are on our problem bank list it should be obvious that management practices and capabilities vary. Because we supervise both sound and unsound institutions we are able to make fair and reasonable judgments about wasteful management practices. It would be an unwise waste of public funds to perpetuate managers, practices or institutions which are destined to failure when the assistance terminates. As we interpret the House bill it only prohibits a request for merger authority as a prior condition to obtaining assistance. It leaves the regulators with authority to impose sanctions and to terminate assistance and merge the bank out of existence if it is determined the bank is failing despite the assistance. Without these authorities we would be strongly opposed to the bill.

1(b): We think the one-half percent figure or any other figure is inappropriate.

Question 2:

S. 2531 authorizes the FDIC and FSLIC to provide capital assistance for any insured institution that meets the eligibility criteria set forth in the bill. Therefore, if a commercial bank meets the criteria, it is eligible for assistance.

(a) What are your views on including commercial banks if they meet the eligibility criteria? Do you believe that is appropriate, or should the legislation be limited to only thrift institutions?

(b) The House bill currently applies more lenient standards for commercial banks by qualifying them for assistance at higher net worth levels than the thrifts. Do you support or oppose that provision? Explain.

Answer:

2(a): As indicated in our testimony, we do not believe the capital assistance provided for in S. 2531 or the House bill is very appropriate for the institutions we insure including commercial banks. Among the commercial banks we supervise we are not aware of any which would qualify being under the bill's criteria. Furthermore, it is important to note that problems being encountered by commercial banks are significantly different than those being encountered by thrifts. We would exclude commercial banks from the bill.

2(b): We cannot perceive any rationale for the provision allowing commercial banks to qualify for support at a higher level of capital. We oppose this provision.

Question 3:

Chairman Pratt opposes including nonfederally insured institutions within the scope of any capital assistance legislation.

(a) What is your agency's position on including state insured institutions?

(b) Describe the regulatory and supervisory complications, if any, that would be entailed by including state insured institutions within this capital assistance bill.

Answer:

3(a): We are totally opposed to the proposition that state-insured institutions should be covered by the Capital Assistance program. Our opposition is considerably more resolute with respect to the Garn assistance plan since the Federal insuring agencies would be using their respective funds as resources for the program. There is no way that we can justify the expenditure of Federal deposit insurance funds to prop up state-insured banks who have not paid into and supported the insurance programs.

Massachusetts is the only state with a state insurance fund that insures mutual savings banks. A couple of years ago, the banking commissioner in that state sponsored legislation to disband the state insurance plan and transfer insurance responsibility for state-insured mutual savings banks to the FDIC. The FDIC cooperated to the fullest extent by agreeing to absorb all of these institutions -- the weak and the strong -- into its system without even requiring that the insurance funds accumulated by the state be turned over to the FDIC (a reasonable indemnity from the state plan would have been required for a limited period).

The proposed legislation was not adopted due to opposition from some state-insured institutions. Nevertheless, the FDIC has since accepted a number of applications from individual savings banks, and firms holding approximately 50 percent of the assets in Massachusetts are now federally insured (no application has been denied by the FDIC).

Some months ago a delegation of state-insured mutuals from Massachusetts met with the Chairmen of the Federal Reserve and FDIC. They wanted assurance that our agencies would assist their state insurance plan should that become necessary. We did not grant the assurance.

We took the position that they could join the Federal insurance system at any time and subject themselves to Federal examination and regulation -- including interest rate ceilings. They would also be required to begin paying insurance premiums to the FDIC.

We were informed by the delegation that our position was unacceptable because these banks did not wish to abide by Federal regulations, did not wish to be examined by a Federal agency and did not wish to pay Federal deposit insurance premiums. We responded that we admired their independence and spirit but could not reconcile their position with their request for assistance from the very Federal agencies they had chosen to eschew. Our position remains the same.

3(b): We believe any state-insured institution applying for assistance under this program should be subject to Federal rules, regulations and insurance premiums. If these institutions choose to remain outside the Federal system of insurance and oversight, they should not be eligible for Federal assistance, irrespective of any indemnification considerations that may be proposed. The individual states, consistent with the spirit of the "New Federalism", should deal with their problems as may be appropriate. Provision of a Federal bailout without any regulatory strings attached would be a great injustice to the vast majority of depository institutions which have financially supported the Federal system and abided by its rules.

Question 4:

The House passed capital assistance bill requires the insurance corporations to consult with the State supervisor of the State in which any state chartered institution is located with respect to the eligibility of such institutions.

What are your views on that provision?

Answer:

We would have no objection to consulting with the appropriate State supervisor of a State-chartered bank in determining its eligibility for capital assistance. In fact, we would undertake such consultation even if not required by the statute so as to have available all relevant input in this regard. However, final decisions regarding the provision of assistance must remain with the Federal insuring agency.

Question 5:

S. 2532 requires the FDIC, in making decisions about "extraordinary acquisitions" of insured banks (Sec. 106), to consult the State bank supervisor of the State in which the bank which is closed or in danger of closing is chartered. The provision gives State supervisors at least 24 hours to object to the determination of FDIC, and if there is an objection, FDIC can proceed only by a unanimous vote of the Board.

Section 102 of S. 2532 permits the FDIC to require a savings bank to convert into a Federal stock savings bank if certain conditions exist (i.e. to prevent a closing or reopen a closed bank, etc.). What is your view on including a provision for State consultation similar to that which is contained in Sec. 106 with respect to "extraordinary acquisitions"?

Answer:

We would have no objection to including in Section 102 of S. 2532 a State consultation requirement similar to the ones in Section 106.

Question 6: What is your view on adding a provision to S. 2531 which would require the FHLBB and the FDIC to promulgate regulations implementing the provisions of the Capital Assistance Act?

Answer:

We do not believe that mandating the issuance of such regulations would serve any useful purpose. In fact, because of the lengthy process normally required by law for issuing regulations, adding such a provision to S. 2531 could very well result in undue delay in utilizing the authority contained in the bill.

Question 7:

The National Association of Mutual Savings Banks has recommended that S. 2532 be amended to provide for full indemnification by the FDIC for savings banks switching to FSLIC insurance. What are you views on this suggestion?

Answer:

We are unalterably opposed to this proposal and have stated on numerous occasions that if such a proposal is contained in the final bill we would recommend to the President that he veto it. Sections 102 through 105 of S. 2532 provide a mechanism for the conversion of mutual savings banks to Federal Charters which is fully supported by the FHLBB and the FDIC and resolves the indemnification problem to our satisfaction.

Nevertheless, we met with the National Association of Mutual Savings Banks on June 14, 1982 in an effort to accommodate their remaining concerns. We are currently working on another proposal which we hope will finally resolve the question. Frankly, our patience is wearing somewhat thin on this issue.

Sincerely,

Bill

William M. Isaac
Chairman

Response to questions of Senator Schmitt (p.136) from William Isaac (FDIC).

June 30, 1982

Honorable Harrison Schmitt
United States Senate
5313 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Schmitt:

You asked that I provide some further clarification to my response to your questions during my testimony on S. 2531. These questions involved the costs to the FDIC Insurance Fund.

If S. 2531 is enacted, FDIC would be called upon to issue income capital certificates to qualifying financial institutions. Little or no cash would be involved but the effect of these certificates would be to sustain the net worth carried on the books of the institution at a high enough level that it could remain in business longer than if those certificates had not been issued. They do not offer a resource that will offer any real help to the institution but they buy some time during which the institution might take actions to help itself if market conditions improve significantly. If this does not happen, FDIC will eventually be called upon to pay off deposits or arrange a merger. If S. 2531 is not enacted we will be required to deal with these institutions in the normal course of events, as we have been doing to date.

We do not believe S. 2531 will materially increase the cost to the FDIC of resolving the problems of these institutions, so long as we are given the flexibility to deny capital support when we lack confidence in management of the institution or when we have an opportunity to arrange a cost-effective merger. The assisted savings banks will lose a given amount of money depending on future interest rates. Ultimately, the FDIC will be called upon to cover those losses. The income capital certificates will not increase the losses and, thus, will not increase the FDIC's exposure.

If we had an opportunity to effect a merger which would result in certain economies, then it would be more costly to go the income capital certificate route. Or, if the assisted institutions had ineffective management, then it could be considerably more costly to permit the income capital certificate alternative in that prolonged exposure to that management would be implicit in an assistance transaction.

I hope this letter has been responsive to your inquiry. Please let us know if we can be of any further assistance.

Sincerely,

William M. Isaac
Chairman

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